Supreme Court, U.S.
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No. _____

In The
Supreme Court of the United States

GENERAL MILLS, INC. & OTHERS,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court For The Commonwealth Of Massachusetts

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the State of Massachusetts is violating the Due Process and Commerce Clauses when it attempts to tax a non-domiciliary corporation's capital gain from an investment unrelated to its Massachusetts business in direct contravention of *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), based upon the non-domiciliary corporation's federal election to treat the capital gain as a deemed asset sale for federal income tax purposes (as allowed by Internal Revenue Code Section 338(h)(10)), thereby attempting to indirectly tax that which it cannot tax directly in contravention of *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458, 464 (2000).

2. Whether the State of Massachusetts is violating the Due Process and Commerce Clauses when it attempts to tax a non-domiciliary corporation's capital gain from an investment unrelated to its Massachusetts business in direct contravention of *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), by applying the federal "step-transaction" doctrine to only *part* of a transaction, in violation of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938).

LIST OF PARTIES

The parties to the proceeding below were General Mills, Inc. and The Talbots, Inc.[1]

RULE 29.6 STATEMENT

Petitioner is comprised of the parent corporation, General Mills, Inc. a publicly traded company, and its former direct, 100%-owned subsidiary, The Talbots, Inc. Diageo, plc owns in excess of 10% of General Mills Inc.'s stock. Other than Diageo, plc, there is no parent or publicly held company owning 10% or more of General Mills, Inc.'s stock.

The tax treatment by Massachusetts of the sale by General Mills, Inc. of the stock of The Talbots, Inc. is at issue in these proceedings. General Mills, Inc. is no longer affiliated with The Talbots, Inc. The Talbots, Inc. remains a party to this matter by virtue of the filing of a combined tax return with Massachusetts for the period at issue that included General Mills, Inc. as the parent corporation, The Talbots, Inc., and other subsidiaries not relevant to the current matter.

As reported in its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, for fiscal year ended 2003: (1) The Talbots, Inc. was

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[1] The Supreme Judicial Court of the Commonwealth of Massachusetts also lists Eddie Bauer, Inc. as a party in a footnote in its decision and order. However, General Mills treatment of its gain received from the sale of its Eddie Bauer, Inc.'s stock is not part of this petition.

RULE 29.6 STATEMENT – Continued

acquired in 1988 by AEON (U.S.A.), Inc. (formerly Jusco (U.S.A.), Inc.); (2) AEON (U.S.A.), Inc. is a wholly owned subsidiary of AEON Co., Ltd. (formerly Jusco Co., Ltd.); (3) The Talbots, Inc. is currently a publicly-traded company with AEON (U.S.A.), Inc. remaining the majority shareholder owning approximately 58.6% of the stock as of February 1, 2003. The Talbots, Inc., 2003 Annual Report 2-3 (2003).

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
LIST OF PARTIES	ii
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	vi
OPINIONS BELOW	1
JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	1
STATEMENT	2
A. Petitioner's Business	3
B. The Transaction	4
C. Massachusetts' Income Tax on Corporations	8
D. The Assessment	8
E. The Proceedings Below	9
REASONS FOR GRANTING THE PETITION	12
I. A STATE CANNOT USE A FEDERAL INCOME TAX ELECTION TO DEFEAT *ALLIED-SIGNAL* DUE PROCESS AND COMMERCE CLAUSE PROTECTIONS AGAINST TAXATION OF GAINS ON THE SALE OF A NON-UNITARY BUSINESS	13
II. A STATE CANNOT PARTIALLY APPLY THE "STEP-TRANSACTION" DOCTRINE TO CIRCUMVENT DECISIONS OF THIS COURT AND ARTIFICIALLY INFLATE A CORPORATION'S TAX LIABILITY	15
CONCLUSION	19

TABLE OF CONTENTS – Continued

Page

APPENDICES

Appendix A:
Opinion of the Supreme Judicial Court of Massachusetts 1a

Appendix B:
Order transferring the appeal sua sponte 31a

Appendix C:
Decision of the Massachusetts Appellate Tax Board 32a

Appendix D:
Findings of Fact and Report of the Massachusetts Appellate Tax Board 34a

Appendix E:
Decision and Order Vacating Decision and Order Under Rule 33 ..... 78a

Appendix F:
Notice of Partial Abatement 82a

Appendix G:
Notice of Denial of Petition for Rehearing 84a

Appendix H:
Massachusetts Statutes Involved 85a

Appendix I:
Relevant Excerpts of I.R.C. § 338 ..... 99a

Appendix J:
Petition for Rehearing 102a

Appendix K:
Combustion Engineering, Inc. v. Commissioner of Revenue, Docket No. F228740, 2000 Mass. Tax LEXIS 17 (Mass. App. Tax Bd. Mar. 29, 2000) 110a

TABLE OF AUTHORITIES

Page

CASES

Allied-Signal, Inc. v. Director, Div. of Taxation,
504 U.S. 768 (1992) ..... *passim*

American States Ins. Co. v. Illinois Dep't of Revenue,
No. 01 L 05940, Ill. St. Tax Rep. (CCH) ¶ 401-410
(Cir. Ct. Cook County Apr. 25, 2003) 12

ASARCO Inc. v. Idaho State Tax Comm'n,
458 U.S. 307 (1982) 3, 8

Canteen Corp. v. Pennsylvania,
818 A.2d 594 (Pa. Commw. Ct. 2003) 12

Combustion Engineering, Inc. v. Commissioner of Revenue,
Docket No. F228740, 2002 Mass. Tax LEXIS 17
(Mass. App. Tax Bd. Mar. 29, 2000) 10n

Commissioner v. Court Holding Co.,
324 U.S. 331 (1945) 16, 17, 18

F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.,
458 U.S. 354 (1982) 3, 8

Hans Rees' Sons v. North Carolina ex rel. Maxwell,
283 U.S. 123 (1931) 19

Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.,
528 U.S. 458 (2000) 2, 8n, 12, 14, 15

Minnesota Tea Co. v. Helvering,
302 U.S. 609 (1938) 16, 17, 18

Mobil Oil Corp. v. Commissioner of Taxes of Vt.,
445 U.S. 425 (1980) 2n, 8

TABLE OF AUTHORITIES – Continued

Page

Osram Sylvania, Inc. v. Pennsylvania,
No. 310 F.R. 1998, Pa. St. Tax Rep. (CCH) ¶ 203-090 (Pa. Commw. Ct. Mar. 6, 2003) 12

Penrod v. Commissioner,
88 T.C. 1415 (1987) 18

Trinova Corp. v. Michigan Dep't of Treasury,
498 U.S. 358 (1991) 15

CONSTITUTION

U.S. Const. art. I, § 8, cl. 3 1

U.S. Const. amend. XIV, § 1 1

STATUTES

28 U.S.C. § 1257(a) 1

IRC § 338(h)(10) ..... *passim*

Mass. Gen. Laws ch. 63, § 30 8

Mass. Gen. Laws ch. 63, § 38 8

Mass. Gen. Laws ch. 63, § 39 8

OTHER AUTHORITIES

Jenkins, *State Taxation of Interstate Commerce,*
27 Tenn. L. Rev. 242 (1960) 15

PETITION FOR WRIT OF CERTIORARI

General Mills, Inc. and Others ("Petitioner") respectfully petition for writ of certiorari to review the judgment of the Supreme Judicial Court for the Commonwealth of Massachusetts in this case.

OPINIONS BELOW

The decision and order of the Supreme Judicial Court of the Commonwealth of Massachusetts (App., *infra,* 1a-30a) is officially reported at 440 Mass. 154, 795 N.E.2d 552 (2003). The Notice of Denial of Petition for Rehearing by the Supreme Judicial Court of the Commonwealth of Massachusetts (App., *infra,* 84a) is not officially reported. The order transferring appeal, *sua sponte*, to the Supreme Judicial Court of the Commonwealth of Massachusetts (App., *infra*, 31a) and the decision and findings of fact and report of the Appellate Tax Board (App., *infra*, 32a-77a) are not officially reported.

JURISDICTION

The judgment of the Supreme Judicial Court of the Commonwealth of Massachusetts was entered on September 15, 2003. The Notice of Denial of Petition for Rehearing was entered on October 29, 2003. The jurisdiction of the Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides, in relevant part: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The Due Process Clause of the United States Constitution, U.S. Const. amend. XIV, § 1, provides, in relevant part: "No state shall . . . deprive

any person of life, liberty, or property, without due process of law."

Relevant portions of the federal Internal Revenue Code and Massachusetts statutes are set forth at App., *infra*, 99a-101a (Internal Revenue Code Section 338) and App., *infra*, 85a-94a (Massachusetts General Laws Section 30).

STATEMENT

In *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 785-88 (1992), the Court affirmed the unitary business requirement, the principle that precludes a State from including in a non-domiciliary corporation's apportionable tax base gains arising from sales of discrete businesses unrelated to a taxpayer's activities in the taxing State. The disputed gain in this case was generated by General Mills, Inc.'s ("General Mills") sale of The Talbots, Inc.'s ("Talbots") stock. The Appellate Tax Board (the trial court for tax cases in Massachusetts) found that Talbots and General Mills did not have a unitary relationship.[2] The Supreme Judicial Court for the Commonwealth of Massachusetts (the "Massachusetts Supreme Judicial Court") affirmed the decision of the Appellate Tax Board. Nevertheless, Massachusetts has attempted to tax the gain resulting from the sale of Talbots by utilizing the federal fiction of Internal Revenue Code Section 338(h)(10)[3] and the "step-transaction" doctrine to circumvent *Allied-Signal* and tax indirectly what it cannot tax directly in contravention of *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458, 464 (2000).

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[2] Under *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980), a unitary relationship is the "linchpin of apportionability."

[3] The Internal Revenue Code is hereinafter referred to as the IRC.

A. Petitioner's Business.

General Mills is a Delaware corporation with its headquarters in Minnesota. It sells packaged food products at the wholesale level. In the early 1970's, General Mills decided to invest in existing companies in different industries. Accordingly, General Mills purchased 100% of the stock of Talbots in 1973. Talbots was a clothing retailer and catalog sales company.

During the period when Talbots was owned by General Mills, Talbots operated its clothing business as an independent, autonomous business – not as an adjunct to General Mills' food products business. Talbots had its own senior management which was responsible for running its business. It had its own employees. It administered its own payroll, training, and benefits programs. It managed its own purchasing, inventory, site selection, and research function. It had its own administrative offices, warehouses, and retail stores. It managed and purchased its own advertising. It prepared its own budget. General Mills' board of directors had no involvement in the affairs of Talbots with the exception of approving major capital expenditures. (App., *infra*, 5a-6a.) That exception does not make unrelated gains apportionable. *See F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354 (1982); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982).

The Appellate Tax Board found no functional integration, no centralized management and no economies of scale between General Mills and Talbots. The Appellate Tax Board concluded that General Mills and Talbots were not part of a unitary business. (App., *infra,* 44a.) The Appellate Tax Board also found that another subsidiary of General Mills, Eddie Bauer, Inc., was not part of a unitary business with General Mills. While the Massachusetts Supreme Judicial Court affirmed this conclusion with regard to Eddie Bauer, Inc. and General Mills, it noted that the Commissioner had not challenged the Appellate Tax Board finding with regard to Talbots.

B. The Transaction.

In 1988, General Mills decided to focus on food products and agreed to sell the stock of Talbots to Jusco Co., Ltd. ("Jusco") for $325 million. The eventual structure of the transaction was dictated by Jusco. It reflects tax planning strategies advantageous to the purchaser, including Jusco's demand for an IRC Section 338(h)(10) election and the alleged separate sale of Talbots' intangible assets (the "Intangibles") for $100 million to Jusco's European subsidiary via an intangible holding company, TalHC, Inc. ("TalHC"). As a condition of the sale, Jusco required (1) the creation of TalHC, (2) the transfer of the Intangibles to TalHC, and (3) the alleged sale of the Intangibles to a Jusco subsidiary for $100 million prior to the sale of Talbots stock to Jusco, with the $100 million sale proceeds being retained by Jusco.

As part of the terms of the stock sale, at Jusco's demand, General Mills made a federal election under IRC Section 338(h)(10) to have the stock sale taxed for *federal income tax purposes* as a deemed sale of the assets of Talbots.[4] Further, as demanded by Jusco, on June 21, 1988, Talbots contributed the Intangibles to TalHC. On

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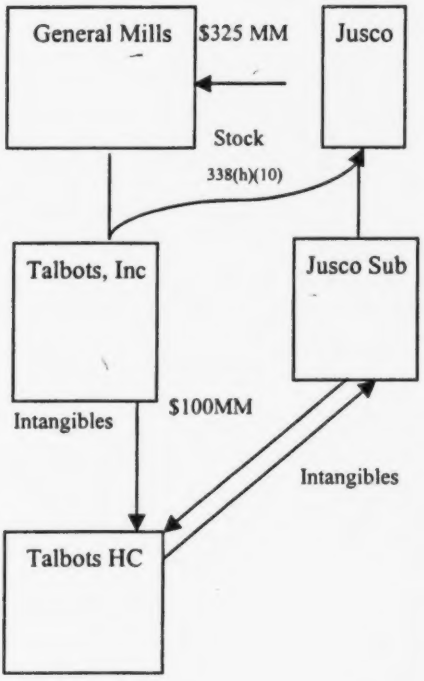
[4] Internal Revenue Code Section 338(h)(10), enacted in 1982, is a commonly-used federal tax election whereby a sale of a target corporation's stock is treated for federal income tax purposes as a deemed sale of the target's assets. Specifically, under this election the target is deemed, for federal income tax purposes, to have sold all of its assets to an unrelated person (*i.e.*, a new corporation and not the actual purchaser of the target's stock) while a member of the selling consolidated group and to have distributed the proceeds in a complete liquidation into the selling group. As a result of the IRC Section 338(h)(10) election, any gain on the sale of the target's stock is disregarded and, instead, a gain from the imaginary sale of the target's assets to the unrelated person is reflected in the consolidated federal income tax return of the selling group. However, the election merely creates a legal fiction for federal tax purposes. The target never actually sold or otherwise disposed of all of its assets.

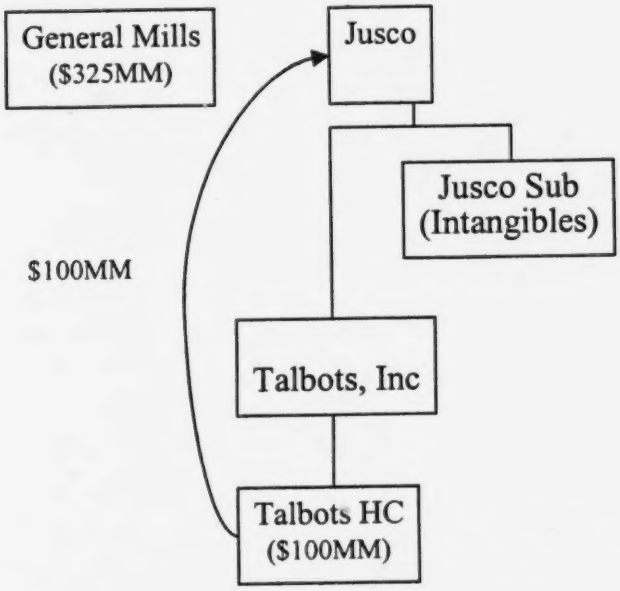
June 26, 1988, Jusco initiated the "$100 million round-trip" through TalHC; this portion of the transaction generates most of the disputed tax herein. Then TalHC allegedly sold the Intangibles to Jusco's subsidiary for $100 million, and TalHC then loaned another Jusco subsidiary the $100 million to help pay the $325 million purchase price to General Mills. This was the corporate structure that Jusco required in order for it to purchase the Talbots stock from General Mills. On June 27, 1988, General Mills received the $325 million. (App., *infra,* 8a-10a.)

As a result of the structure mandated by Jusco, General Mills never received $100 million for the sale of the Intangibles. In a "$100 million round-trip," the $100 million paid by Jusco's European subsidiary to TalHC was immediately lent to Jusco's United States' subsidiary. On the following day Jusco acquired the stock of Talbots and thereby owned its subsidiary, TalHC, and the $100 million in proceeds. The $100 million was used by Jusco to help finance the $325 million purchase of Talbots stock. At the completion of the transaction, General Mills received $325 million, as intended from the outset. (App., *infra*, 9a-10a.) General Mills did not receive $425 million.

Steps in the Sale of Talbots



End Result



The $100,000,000 Jusco paid for the intangibles came back to Jusco when the stock was transferred.

Therefore, Jusco only paid $325,000,000 for Talbots, including the Intangibles. Jusco did not pay $425,000,000.

C. Massachusetts' Income Tax on Corporations.

Massachusetts imposes a corporate income tax on Massachusetts net income. Mass. Gen. Laws ch. 63, § 30. (App., *infra*, 85a-94a.) Gains from sales of non-unitary investments are not included in apportionable income of non-domiciliary corporations. Mass. Gen. Laws ch. 63, § 38. (App., *infra*, 94a-96a.) General Mills' sale of its Talbots stock resulted in a gain from a non-unitary investment and should not have been included in Petitioner's apportionable income. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354 (1982); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980).

If a corporation has income generated by business activities taxable in a number of states, including Massachusetts, the amount of income attributable to and taxable by Massachusetts is computed by the application of a three-factor ratio of property, payroll and sales to apportionable income. The resulting apportioned net income is subject to tax. Mass. Gen. Laws ch. 63, § 39.[5] (App., *infra*, 96a-98a.)

D. The Assessment.

The Massachusetts Department of Revenue conducted an audit of Petitioner's fiscal year 1989 Massachusetts corporate income tax return. On February 7, 1992, the

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[5] As the Court explained in *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458, 461 (2000): "If, for example, an Illinois tin can manufacturer, doing business in California and elsewhere, earns $10 million from its total nationwide tin can sales, and if California's formula determines that the manufacturer does 10% of its business in California, then California will impose its income tax upon 10% of the corporation's tin can income, $1 million."

Commissioner assessed $10,856,588 in additional taxes, substantially arising from General Mills' stock sale of Talbots. (App., *infra,* 37a.)

Apparently in recognition of *Allied-Signal*, the Commissioner did not attempt to directly tax the Talbots stock sale. However, the Commissioner did tax the IRC Section 338(h)(10) deemed sale of Talbots' assets and the phantom $100 million which neither General Mills nor Talbots ever received. Compounding the taxation of these phantom gains, the Commissioner included the phantom $100 million in the Massachusetts sales factor numerator, causing the proposed liability to inflate exponentially.

Petitioner timely filed an Application for Abatement. (App., *infra,* 82a.) Petitioner's Application was denied. In September 1994, Petitioner timely filed an appeal with the Appellate Tax Board. (App., *infra,* 38a.)

E. The Proceedings Below.

During the proceedings before the Appellate Tax Board, Petitioner raised, among other issues: (i) whether the gain from the sale of Talbots stock was subject to apportionment by Massachusetts as part of General Mills' unitary business; (ii) whether the federal election made pursuant to IRC Section 338(h)(10) required Talbots to include the fictional gain realized from the deemed sale of assets in its Massachusetts apportionable income; (iii) whether the alleged gain realized from the "sale" of the Intangibles was required to be included in Talbots' Massachusetts income; and (iv) whether the alleged proceeds from the sale of the Intangibles should be included in the numerator of Talbots' sales factor when calculating its Massachusetts apportionable income. (App., *infra,* 36a-37a.)

The Appellate Tax Board agreed with Petitioner that Talbots was not unitary with General Mills. However, the Appellate Tax Board determined that, based on the federal IRC Section 338(h)(10) election, the gain on the hypothetical sale of Talbots assets is apportionable. The Appellate

Tax Board also applied the step-transaction doctrine to only a portion of the transaction, collapsing only Talbots' transfer of the Intangibles to TalHC (steps (1) and (2) explained, *supra*, page 4) but recognizing the phantom $100 million gain on the sale of the Intangibles (step (3) explained, *supra*, page 4) as apportionable even though the $100 million was never actually received by General Mills or by Talbots. It also held that, notwithstanding the collapse of steps (1) and (2), the Intangibles could not be part of the assets "deemed" to have been sold under IRC Section 338(h)(10). (App., *infra*, 44a-51a.) Since payment received for an IRC Section 338(h)(10) transaction is not included in the sales factor numerator, this holding allowed the Commissioner to include the phantom $100 million in General Mills' Massachusetts numerator.[6]

Petitioner timely appealed to the Massachusetts Appeals Court. At page one of its brief to the Massachusetts Appeals Court, Petitioner presented the following issues:

> 1. Did the Appellate Tax Board ("Board") err when it concluded that, where an election was made for federal income tax purposes under Internal Revenue Code ("IRC") §338(h)(10) to treat the sale of The Talbots, Inc.'s ("Talbots") stock as a deemed sale by Talbots of all of its assets, the substance of the transaction (*i.e.*, the stock sale) should be ignored and, instead, the federal fictitious gain should be taxed by Massachusetts?
>
> 2. Did the Board err when it (A) approved the Commissioner of Revenue's ("Commissioner") disregarding of Talbots' creation of, and transactions with, a subsidiary, TalHC, Inc. ("TalHC") and then, (B) determined that the gain from

[6] *See Combustion Engineering, Inc. v. Commissioner of Revenue*, No. F228740, 2000 Mass. Tax LEXIS 17, at *10 (Mass. App. Tax Bd. Mar. 29, 2000). (App., *infra*, 117a.)

TalHC's sale of intangibles should be included in Talbot's Massachusetts income?

3. Did the Board err when it concluded that the receipts from the sale by TalHC of its intangibles should be included in the numerator of Talbots' sales factor?

Prior to argument in the Massachusetts Appeals Court, the Massachusetts Supreme Judicial Court took the appeal directly on its own motion and affirmed the Appellate Tax Board's decision. (App., *infra,* 31a.) The Massachusetts Supreme Judicial Court denied Petitioner's request for rehearing. (App., *infra,* 84a.)

The Massachusetts Supreme Judicial Court concluded that the IRC Section 338(h)(10) election, made solely for federal income tax purposes, to have the stock sale of Talbots taxed as a fictional asset sale, permitted Massachusetts to apportion the fictional gain since it appeared on General Mills' consolidated federal income tax return. (App., *infra,* 23a-24a.) The Massachusetts Supreme Judicial Court held that Petitioner had not raised any Due Process issues on appeal and therefore had waived its Due Process arguments. (App., *infra,* 18a, n.7.) Petitioner, in its Petition for Rehearing, set forth the relevant pages of its brief on appeal containing its Due Process arguments. (App., *infra,* 107a, n.2.) The Order denying the Petition for Rehearing does not contain any response to those points. Furthermore, the Supreme Judicial Court never specifically addressed the Commerce Clause issues.

In addition, the Massachusetts Supreme Judicial Court upheld the partial application of the step-transaction doctrine – it disregarded the transfer of the Intangibles to TalHC, but it did not disregard the $100 million "sale" of the Intangibles to the Jusco subsidiary prior to the sale of Talbots' stock to Jusco. (App., *infra,* 24a-28a.) The court then held that the gain on the "sale" of the Intangibles is apportionable by Massachusetts and is included in Talbots' sales factor numerator. (App., *infra,* 28a-29a.)

REASONS FOR GRANTING THE PETITION

This case presents issues of paramount importance. Many multistate and multinational taxpayers have gains on the sale of discrete business entities, where the transaction is the subject of an IRC Section 338(h)(10) election. *See, e.g., Osram Sylvania, Inc. v. Pennsylvania*, No. 310 F.R. 1998, Pa. St. Tax Rep. (CCH) ¶ 203-090 (Pa. Commw. Ct. Mar. 6, 2003); *Canteen Corp. v. Pennsylvania*, 818 A.2d 594 (Pa. Commw. Ct. 2003); and *American States Ins. Co. v. Illinois Dep't of Revenue*, No. 01 L 05940, Ill. St. Tax Rep. (CCH) ¶ 401-410 (Cir. Ct. Cook County Apr. 25, 2003).

There are two compelling reasons for the Court to grant review of the decision below. First, the decision raises an issue of utmost importance to the Court's Due Process and Commerce Clause jurisprudence: whether a State may apportion the gain of a non-domiciliary corporation arising from the sale of a discrete business when that company elects for federal income tax purposes to have the stock sale taxed as though it were an asset sale (herein referred to as an IRC Section 338 election).

In 1992, in *Allied-Signal, Inc. v. Director, Division of Taxation*, the Court confirmed the unitary business principle as a protection from overreaching State taxation under the Due Process and Commerce Clauses. 504 U.S. 768 (1992). The ruling in that landmark case answers the first question in the negative – a State may not apportion the gain of a non-domiciliary corporation arising from the sale of a discrete business. Massachusetts seeks to avoid the constitutional limits afforded by *Allied-Signal* and tax the Talbots gain on the basis of a federal income tax election. In *Hunt-Wesson*, the Court ruled that a state is prohibited from taxing indirectly that which it is constitutionally prohibited from taxing directly. The Court should grant review to reinforce the constitutional safeguards it established in *Allied-Signal*.

Second, the Massachusetts Supreme Judicial Court's decision raises another issue of utmost importance to the Court's Due Process and Commerce Clause jurisprudence:

whether Massachusetts can selectively apply the "step-transaction" doctrine to only part of an entire transaction in order to tax the sale of the Intangibles. If the step-transaction doctrine were applied to the entire transaction, (1) the transfer of the Intangibles would be disregarded, (2) the Intangibles would not be deemed to have been sold separately, and (3) the sales factor numerator would not have been inflated. Therefore, the Court should grant review to address whether the step-transaction doctrine, as developed by the federal courts, may be selectively applied by a state to only part of a transaction to circumvent the decisions of the Court.

I. A STATE CANNOT USE A FEDERAL INCOME TAX ELECTION TO DEFEAT *ALLIED-SIGNAL* DUE PROCESS AND COMMERCE CLAUSE PROTECTIONS AGAINST TAXATION OF GAINS ON THE SALE OF A NON-UNITARY BUSINESS

Under the unitary business principle, Massachusetts may not apportion, and thereby tax, the gain on General Mills' sale of stock of Talbots since that sale of stock has no relationship to General Mills' activities in Massachusetts. The unitary business principle is a necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to a taxpayer's activities within the State. *Allied-Signal, Inc. v. Director, Div. of Taxation,* 504 U.S. 768, 780 (1992). The unitary business principle's genesis is thus:

> there must be "a 'minimal connection' between the interstate activities and the taxing State," and there must be a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business. . . . A State may not tax a nondomiciliary corporation's income, however, if it is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'"

Id. at 772-73 (citations omitted). The Court has also stated that a state cannot tax indirectly that which the Constitution prohibits it from taxing directly. *Hunt-Wesson, Inc. v. California Franchise Tax Bd. of Cal.*, 528 U.S. 458, 464 (2000).

Similar to the facts in *Allied-Signal*, General Mills and Talbots were operationally unrelated business enterprises each of whose activities had nothing to do with the other. The Appellate Tax Board found as much, App., *infra*, 40a-44a, and the Massachusetts Supreme Judicial Court did not reverse that finding.

However, the Massachusetts Supreme Judicial Court agreed with the Appellate Tax Board's determination that, although the IRC Section 338(h)(10) election was made for federal income tax purposes, the election defeated the limits outlined by the Court in *Allied-Signal* that protect non-domiciliary companies from being taxed by a State on income from discrete business enterprises.

According to the Massachusetts Supreme Judicial Court, if the facts in *Allied-Signal* were the same as they were except that the seller owned a greater percentage of the target's shares, and an IRC Section 338(h)(10) election had been made with respect to the sale of the stock, then the gain from the sale would have been apportionable, notwithstanding that the election is made for federal tax reporting purposes. Such a circumvention of the Court's jurisprudence should not be allowed.

Under IRC Section 338(h)(10), an election is made whereby a stock sale is taxed as if it was an asset sale. The fact that the Internal Revenue Code permits a company selling all of the stock in a wholly-owned subsidiary to pay federal income tax as though the transaction was an asset sale does not alter the underpinnings, and thereby the protections, of the Court's holding in *Allied-Signal*. Therefore, that federal election should not create, or be the source of, a relationship sufficient to permit a non-domiciliary State to apportion the gain.

Simply stated, Massachusetts is constitutionally prohibited from taxing the gain on General Mills' (a non-domiciliary company's) sale of stock in a business with which it is not in a unitary relationship. The federal IRC Section 338(h)(10) election does not alter the transaction – a sale of stock – so as to obviate the limits placed on state taxation in *Allied-Signal*. As the Court observed in *Hunt-Wesson*, a "'tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.'" 528 U.S. at 464 (citing *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (quoting Jenkins, *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 242 (1960))).

Because Massachusetts used Petitioner's federal election to defeat the protections confirmed in *Allied-Signal*, an event not contemplated by or addressed in *Allied-Signal*, the Court should grant Petitioner's petition.

II. A STATE CANNOT PARTIALLY APPLY THE "STEP-TRANSACTION" DOCTRINE TO CIRCUMVENT DECISIONS OF THIS COURT AND ARTIFICIALLY INFLATE A CORPORATION'S TAX LIABILITY

The authority of a state to tax income of a multistate corporation is limited by the Due Process and Commerce Clauses. Massachusetts partial application of the step-transaction doctrine violated the Due Process and Commerce Clauses.

The step-transaction doctrine, a doctrine arising from the federal courts, must be applied to an entire transaction or not at all, with the result being the taxation of either the substance or the form of a transaction. If a State chooses to apply the federal step-transaction doctrine, it must apply it completely as intended by the federal courts as discussed *infra*, not as a middle-ground selected arbitrarily by a State, as is the situation before the Court in this petition. Massachusetts disregarded the form of the

sale of the Intangibles, but created a hypothetical substance to overtax General Mills.

The Massachusetts Supreme Judicial Court determined that Talbots contribution of the Intangibles to TalHC was a scheme with no legitimate business purpose beyond tax avoidance. (App., *infra,* 24a-26a.) However, as the court below recognized, Petitioner did not create this scheme – Jusco "sought a modification to the agreement, for its own purposes." (App., *infra,* 8a.) The Massachusetts Supreme Judicial Court viewed the transactions as collectively resulting in a sale of the entire company. But it did not fully apply the step-transaction doctrine because it did not collapse or ignore all of the intermediate transactions involving TalHC. The complete and correct application of the step-transaction doctrine requires that the sale of the Intangibles from TalHC to the Jusco subsidiary for the phantom $100 million be collapsed into Talbots and viewed in its proper light, *i.e.*, that nothing happened and that the Intangibles were assets owned by Talbots which, if taxable at all, are taxable as part of the deemed sale under IRC Section 338(h)(10).

After citing the Court's precedents on the step-transaction doctrine (*Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) and *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938)), the Massachusetts Supreme Judicial Court concluded that the step-transaction doctrine should be applied to the transaction involving TalHC and the movement of the Intangibles:

> The intermediate transaction served no legitimate business purpose and was designed solely to avoid a Massachusetts tax. It is immaterial that the end result may have been for legitimate business purposes. If an intermediate step has no legitimate business purpose beyond tax avoidance, it may be collapsed for tax purposes under the step transaction doctrine.

(App., *infra,* 26a.)

Notwithstanding the court's holding that the transactions should be collapsed, the Massachusetts Supreme Judicial Court did not fully apply the step-transaction doctrine. As this Court stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed *as a whole*, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title.

Court Holding Co., 324 U.S. at 334 (emphasis added). *See also Minnesota Tea Co.*, 302 U.S. at 613 ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

In *Court Holding*, the shareholders negotiated the sale of a corporation, but instead (1) distributed its only asset to its shareholders, who then (2) conveyed the asset to the purchaser. 324 U.S. at 332-33. The *Court Holding* Court disregarded the "imaginary" transfer of the asset, step (1), and the asset sale by the shareholders, step (2), thus collapsing both steps. The *Court Holding* Court treated the transaction as what it was in reality – a sale of stock – and held that the transfer was a nullity because it was in substance a sale of the corporation to the purchaser. *Id.* at 333-34. The Court disregarded the asset transfer, collapsed the transfer into the corporation, and held the transactions to be taxed as if the scheme had not been perpetrated. *Id.* at 333-34. The Court did not disregard only a part of the transaction, it collapsed the entire transaction.

In *Minnesota Tea*, the stockholders arranged for the sale of the corporation's assets but immediately (1) transferred the corporation's debts to its stockholders, (2) transferred the corporation's cash proceeds, from the asset

sale, to the corporation's stockholders and (3) then the stockholders used the distributed cash proceeds to pay the distributed debts, all under the guise of a reorganization. 302 U.S. at 611-12. The Court in *Minnesota Tea* held that the three-step scheme was in substance a sale by the corporation, although in form it was a reorganization. *Id.* at 612. The Court disregarded the transfers, steps (1) and (2), and the debt-payment, step (3), collapsed the transfers and the debt-payment into the corporation, and held that the transaction is to be taxed as if the scheme had not been perpetrated. Here, too, the Court did not disregard only a part of the transaction, it collapsed the entire transaction.

Finally, the United States Tax Court describes the step-transaction doctrine as a "rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987).

If the step-transaction doctrine as prescribed by the Court in *Court Holding* and *Minnesota Tea*, as well as the U.S. Tax Court in *Penrod*, is applied to the facts at issue in this petition, the substance and intended result of the transaction dictates that the sale of the Intangibles be ignored.

The Massachusetts Supreme Judicial Court allowed Massachusetts to disregard TalHC's sale of the Intangibles – it disregarded a portion of the transaction. But it then allowed the recognition of the remainder of the transaction, thereby, allowing Massachusetts to (a) impose a tax on the $100 million that was never received and (b) include that $100 million in the numerator of the Massachusetts sales factor, causing General Mills' tax liability to be inflated.

Because Massachusetts applied the step-transaction doctrine to only part of the transaction at issue, Massachusetts in effect partially applied the step-transaction doctrine for the sole purpose of increasing Petitioner's

apportionable tax base. As a result, Massachusetts' apportionment of Petitioner's income is distortive because it is disproportionate to Petitioner's business activity in Massachusetts, in violation of the Due Process and Commerce Clauses and the Court's prohibition of such distortive apportionment in *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

CONCLUSION

The decision by the Massachusetts Supreme Judicial Court disregards the Due Process and Commerce Clause protections established by the Court and allows Massachusetts to apportion an investment gain resulting from the stock sale of a non-unitary business. Such a disregard for the unitary business principle and the step-transaction doctrine produces two issues of enormous significance that demand the Court's attention.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

COMMONWEALTH OF MASSACHUSETTS

SUPREME JUDICIAL COURT FOR THE COMMONWEALTH

AT BOSTON, 15 September 2003

IN THE CASE NO. SJC-08935

GENERAL MILLS, INC., & OTHERS

VS.

COMMISSIONER OF REVENUE

pending in the Appellate Tax Board No. F223398

ORDERED, that the following entry be made in the docket, viz., –

The decision of the Appellate Tax Board is affirmed

BY THE COURT,

/s/ Susan Miller
Clerk
Supreme Judicial Court
For the Commonwealth

DATED September 15, 2003
See opinion on file

SJC-08935

GENERAL MILLS, INC., & others[1] *vs.* COMMISSIONER OF REVENUE.

[1] Talbots, Inc., and Eddie Bauer, Inc.

Suffolk. May 8, 2003. – September 15, 2003.

Present: Greaney, Ireland, Spina, Cowin, Sosman, & Cordy, JJ.

Taxation, Abatement, Corporation, Excise, Corporate excise, Apportionment of tax burden, Related corporations. *Corporation*, Subsidiary, Stock. *Trade Name. Trademark*.

Appeal from a decision of the Appellate Tax Board.

The Supreme Judicial Court on its own initiative transferred the case from the Appeals Court.

Paul H. Frankel, of New York (*Craig B. Fields*, of New York, & *Maxwell D. Solet* with him) for the taxpayers.

Thomas K. Condon, Special Assistant Attorney General (*Michael T. Fatale*, Special Assistant Attorney General, with him) for Commissioner of Revenue.

SPINA, J. In 1988, General Mills, Inc., a Delaware corporation doing business in Massachusetts, sold its interest in two wholly owned subsidiaries: Eddie Bauer, Inc., a foreign corporation, and Talbots, Inc., a Massachusetts corporation. The corporations paid corporate excise taxes assessed and self-assessed for the fiscal year involved, then filed an application for abatement with the Commissioner of Revenue (commissioner). The application was denied. Three items for which abatement was sought are the subject of this appeal. The first involved an apportionable tax assessed to General Mills, after audit, on the gain it realized from the sale of its Eddie Bauer stock, where the commissioner determined that Eddie Bauer functioned as part of General Mills's unitary business in Massachusetts. The

second involved a self-assessed tax based on income that Talbots had reported, allegedly in error, as its own but in fact was the gain realized by General Mills from the sale of its Talbots stock, where both corporations had joined the purchaser of the stock in an election under I.R.C. § 338(h)(10), 26 U.S.C. § 338(h)(10) (1988), to treat the stock sale as a sale of Talbots's assets. The third concerned an additional tax assessed on Talbots, after audit, on the gain from a sale of the Talbots trademarks and trade names (intangibles) by its wholly owned Delaware subsidiary, Tal HC, Inc. The commissioner determined that Talbots had transferred its intangibles to Tal HC five days before the sale for no consideration, for no legitimate business purpose, and solely to avoid a Massachusetts tax. He then applied the step transaction doctrine and attributed the gain directly to Talbots.

General Mills and its subsidiaries appealed to the Appellate Tax Board (board) under its formal procedure, contending that because the subsidiaries were independently run businesses and not part of General Mills's unitary business in Massachusetts, the gain from the sales of stock could not, consistent with constitutional principles, be taxed. General Mills and Talbots also argued that the deemed sale of Talbots's assets could not be taxed by the Commonwealth because it was a fictitious transaction resulting from an election under the Internal Revenue Code that was not recognized by Massachusetts and produced no income in Massachusetts. They also claimed that the transfer and ultimate sale of the Talbots intangibles could not be taxed because neither General Mills nor Talbots had received the proceeds of that sale, or alternatively, that the gain from the sale of the intangibles should be regarded as an out-of-State sale of stock.

The board found that, although the three corporations did business in Massachusetts, neither subsidiary was engaged in a unitary business with General Mills in Massachusetts. The board concluded that the subsidiaries "had no rational relationship to General Mills' Massachusetts business. Therefore . . . taxing General Mills' gain realized from the sale of stock in these entities would result in the [unconstitutional] taxation of extraterritorial values." The board ordered an abatement and refund of the tax assessed on the sale of the Eddie Bauer stock.

However, because General Mills and Talbots had made an election under I.R.C. § 338(h)(10) to treat the sale of Talbots's stock as a sale of its assets and consequently reported the gain from that sale on their Federal consolidated return as income to Talbots, the board determined that the gain from that sale was properly included in Talbots's Massachusetts net income on its combined Massachusetts return with General Mills. The board also concluded that the gain from the sale of Talbots's intangibles by Tal HC was taxable to Talbots because Talbots's transfer of its intangibles to Tal HC "lacked economic substance beyond the mere creation of tax benefits," and that the commissioner properly included the gain from the sale of the intangibles in the numerator of the apportionment formula used to calculate Talbots's additional tax liability. General Mills and Talbots appealed from the portions of the board's decision pertaining to the sale of Talbots's stock and intangibles; the commissioner appealed from the decision as to the sale of the Eddie Bauer stock. We transferred the case from the Appeals Court on our own motion, and affirm the decision of the board.

1. *Facts.* The salient facts are not disputed, but some inferences drawn by the board are disputed. General Mills

is a Delaware corporation with its corporate headquarters in Minneapolis, Minnesota. It is engaged in producing and selling packaged food products at wholesale. In the early 1970's, it began to invest in existing companies in different industries. In 1971, General Mills purchased one hundred per cent of the stock of Eddie Bauer, Inc., a foreign corporation engaged in the business of retail sale of sporting goods and sports clothing, with its corporate headquarters in Seattle, Washington. In 1973, General Mills acquired one hundred per cent of the stock of Talbots, Inc., a Massachusetts corporation with corporate headquarters in Hingham. Talbots is a clothing retailer and catalog sales company. In 1988, General Mills sold its interest in both companies. At all relevant times the three companies did business in Massachusetts.

a. *Relationship between parent and subsidiaries.* The board found that, for purposes of taxation, neither Talbots nor Eddie Bauer had a unitary business relationship with General Mills because "there was no significant functional integration, centralized management or economies of scale realized by [General Mills] and its subsidiaries."[2] During General Mills's ownership of Eddie Bauer and Talbots, Eddie Bauer had its own senior management responsible for preparing its own budget and running its business from the State of Washington. Talbots also had its own management team, which conducted its affairs from

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[2] The commissioner only challenges the board's finding as to Eddie Bauer, contending that the board's determination as to Talbots's relationship with General Mills, while erroneous, had no practical effect on the decision, where General Mills and Talbots made the election under I.R.C. § 338(h)(10), 26 U.S.C. § 338(h)(10) (1988).

Massachusetts. Each subsidiary had its own employees and administered its own employee related functions, such as training, payroll, and benefits. Each managed its own purchasing, inventory, site selection, and research functions, separate from General Mills. And each maintained its own administrative offices, warehouses, and retail stores, none of which was shared with General Mills. The two subsidiaries shared no centralized purchasing or advertising functions with the parent. Although General Mills and its subsidiaries shared some officers and directors, it was sporadic and they had no involvement in the day-to-day operations of the subsidiaries.

General Mills provided some services to its subsidiaries. It loaned them money on an "as needed basis" with interest at commercial rates. It guaranteed a subsidiary's lease whenever required by the landlord, and it would guarantee revenue bonds to finance major capital projects undertaken by a subsidiary. It permitted a subsidiary's employee pension plan to invest in General Mills's pooled retirement funds. General Mills provided legal and tax services to its subsidiaries, charging a pro rata share of the legal fees. It did not charge either subsidiary a fee for the tax service because the New York Stock Exchange and the Securities and Exchange Commission (SEC) required wholly owned subsidiaries to file tax returns on a consolidated basis with the parent corporation. Consequently, General Mills decided that it was more efficient and practical to have the necessary returns prepared by the same tax expert, and it absorbed the entire cost.

General Mills provided administrative support to Talbots and Eddie Bauer through its "specialty retailing group" (SRG) staffed at various times by fifteen to eighteen employees on General Mills's payroll. The SRG

assisted the subsidiaries in preparing requests for funding from General Mills for major capital projects, and in the preparation of financial and operational reports required by General Mills, as well as other areas of management. The cost of maintaining the SRG, which was located in New York, was born by the subsidiaries. General Mills provided each subsidiary, cost free, use of the other's proprietary customer list. Talbots's list was "one of the most sought after, highest performing and accurately addressed lists in the industry."

In its 1979 stock prospectus, General Mills represented that "it produce[d] and [sold] apparel, accessories and other fashion items . . . and recreational shoes." In its SEC Form 10-K and Annual Report for 1986, it represented that it was engaged in competition in three industry areas, including "Specialty Retailing." In its 1987 annual report, General Mills stated that Eddie Bauer was one of its "Major Growth Businesses" and that Talbots was one of its "three core businesses," which collectively generated forty-six per cent of the company's total 1987 income.

b. *Sale of Talbots's stock.* On May 18, 1988, following negotiations with Jusco Co., Ltd. (JCL), General Mills entered into an agreement with Jusco (U.S.A.), Inc., a Delaware subsidiary of JCL, for the purchase and sale of Talbots's stock. The parties agreed that General Mills would receive $3 million as consideration for joining with JCL, if requested, in an election under I.R.C. § 338(h)(10) to treat the sale of Talbots's stock as a sale of its assets. The $3 million figure was based on an estimate of the increased Federal tax liability that would result from such an election, and the understanding that there would be no State tax liability.

On May 30, 1988, JCL sought a modification to the agreement, for its own purposes. It proposed that "[i]mmediately prior to the sale of Talbots shares by General Mills, Talbots will sell [its] trademark/tradename intangibles to Jusco (Europe), B.V., in the Netherlands [another JCL subsidiary] for a purchase price to be based on an evaluation by [the accounting firm] Touche Ross, which will be deducted from the total U.S. $325 million to be paid for Talbots shares." General Mills agreed, subject to a determination of increased tax liabilities and a satisfactory indemnification agreement.

On June 9, 1988, in response to General Mills's concern that the proposed sale of Talbots's intangibles to Jusco (Europe) would create a taxable dividend in Massachusetts, JCL proposed an alternative plan to eliminate any potential Massachusetts tax to General Mills. Under the alternative plan, Talbots would create a Delaware corporation to which it would transfer its zero basis intangibles. The new corporation would then sell the intangibles to Jusco (Europe) for $100 million. The consideration for the sale of Talbots's stock would be $325 million. After the sale of the stock, the new corporation, which would then be controlled by Jusco (U.S.A.), would lend to Jusco (U.S.A.) the $100 million proceeds from the sale of intangibles. Jusco (U.S.A.) would use the money to pay down the $325 million loan it obtained to acquire the Talbots stock. It was understood that by shifting the taxable transaction for the sale of Talbots's intangible assets from Massachusetts to Delaware, there would be no Massachusetts tax on the gain, and because there is no income tax in Delaware, General Mills would incur no State tax from the sale of Talbots's intangibles. At some future date, the new Delaware corporation would be

liquidated. General Mills agreed to the alternative plan. Because it understood that Massachusetts might challenge the scheme, General Mills initially requested a hold harmless agreement but abandoned that request when it became satisfied that the alternative plan was tax neutral.

The alternative plan to sell the Talbots intangibles was carried out. On June 17, 1988, General Mills incorporated Tal HC, Inc., a Delaware corporation, as a wholly owned subsidiary of Talbots. Talbots assigned its intangibles to Tal HC on June 21, 1988. Tal HC licensed the intangibles back to Talbots[3] the same day with no provision for royalty payments. On June 26, 1988, Tal HC sold the Talbots intangibles to Jusco (Europe) for $100 million. Prior to that date, Tal HC had no employees and no liabilities. Its assets consisted of the Talbots intangibles and ten dollars it received from Talbots for Tal HC's stock. Its only business activities during this time were those just described. Also on June 26, Jusco (Europe) licensed the Talbots intangibles back to Talbots. That licensing agreement contained a provision for royalty payments based on a percentage of sales. Jusco (Europe) received royalty payments from Talbots that averaged more than $24,000 each day from July, 1988, through December, 1988. Tal HC had received no royalty payments for the six days it owned the intangibles.

On June 27, 1988, General Mills sold its Talbots stock to Jusco (U.S.A.) for $325 million. After the sale Tal HC, which was then controlled by Jusco (U.S.A.) by virtue of its

[3] The licensing agreement was considered necessary to protect the trademarks and trade names.

ownership of Talbots's stock, loaned to Jusco (U.S.A.) the $100 million that it received from Jusco (Europe) on June 26, 1988. Jusco (U.S.A.) applied the $100 million to the $325 million loan it obtained to acquire the Talbots stock. These steps were taken pursuant to JCL's June 9, 1988, alternative plan. Approximately nine months later, General Mills and Talbots joined Jusco (U.S.A.) in an election under I.R.C. § 338(h)(10). Consequently, General Mills filed a 1989 Federal consolidated return and a combined Massachusetts return that both treated the sale of Talbots's stock as a sale of assets by Talbots. General Mills reported Tal HC's sale of Talbots's intangibles on the consolidated Federal return as a direct sale of assets by Tal HC. It could not include the sale of intangibles in the I.R.C. § 338(h)(10) election because it took place the day before the sale of Talbots's stock.

2. *Sale of the Eddie Bauer stock.* The commissioner contends that the board erroneously determined that there was no unitary business relationship between General Mills and Eddie Bauer and misapplied the test used to determine the existence of such a relationship. Findings of the board are final, see G. L. c. 58A, § 13, and will not be disturbed if they are supported by sufficient evidence. "Our review of the sufficiency of the evidence is limited to 'whether a contrary conclusion is not merely a possible but a necessary inference from the findings.'" *Olympia & York State St. Co.* v. *Assessors of Boston,* 428 Mass. 236, 240 (1998), quoting *Kennametal, Inc.* v. *Commissioner of Revenue,* 426 Mass. 39, 43 (1997), cert. denied, 523 U.S. 1059 (1998). The credibility of witnesses, the weight of the evidence, and inferences that reasonably may be drawn from the evidence are matters for the board. See *Kennametal, Inc.* v. *Commissioner of Revenue, supra* at 43 n.6. If

the decision of the board is supported by sufficient evidence, it will not be set aside unless it is based on an error of law. See *Syms Corp.* v. *Commissioner of Revenue,* 436 Mass. 505, 511 (2002).

As a general rule, the commerce clause and the due process clause of the United States Constitution prohibit a State from imposing a tax on value earned outside its borders. See *ASARCO Inc.* v. *Idaho State Tax Comm'n,* 458 U.S. 307, 315 (1982). However, a State may tax a nondomiciliary corporation on an apportionable share of its interstate business provided there is a "'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'"[4] *Exxon Corp.* v. *Department of Revenue of Wis.,* 447 U.S. 207, 219-220 (1980), quoting *Mobil Oil Corp.* v. *Commissioner of Taxes,* 445 U.S. 425, 436, 437 (1980). This is known as the unitary business principle. It permits a State to apportionably tax a nondomiciliary corporation on income received from a subsidiary, even if the subsidiary does no business in the taxing State, provided the income is attributable to the subsidiary's operational involvement in the parent's interstate business that is subject to apportionable taxation by the State. See *Container Corp. of Am.* v. *Franchise Tax Bd.,* 463 U.S. 159, 165-166 (1983); *Mobil Oil Corp.* v. *Commissioner of Taxes, supra* at 438.

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[4] Here, because part of Eddie Bauer's own interstate business was conducted in Massachusetts, Eddie Bauer paid an apportionable tax on its income to Massachusetts.

The test used to determine the existence of a unitary business relationship between a corporation and its subsidiary for purposes of assessing an apportionable tax focuses on whether "contributions to income result[ ] from functional integration, centralization of management, and economies of scale." *Id.* See *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 179. The United States Supreme Court has not decided whether any one factor under this test would be sufficient to establish the existence of a unitary business. *Id.* at 179-180. A State may not tax a nondomiciliary corporation's income that is derived from a subsidiary's unrelated business activity that constitutes a discrete business enterprise. See *id.* at 166; *Mobil Oil Corp.* v. *Commissioner of Taxes, supra* at 439, 442. The burden is on the taxpayer to show "by 'clear and cogent evidence' that [the State tax] results in extraterritorial values being taxed." *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 164, quoting *Exxon Corp.* v. *Department of Revenue of Wis., supra* at 221.

The commissioner contends that the "centralized management" test was satisfied by the management direction that General Mills provided to Eddie Bauer through its hierarchical SRG staffed by General Mills officers; by the guidelines imposed on Eddie Bauer that determined key issues, corporate strategy, and economic targets; and by the officers and directors that they shared. We disagree. Although there were "some managerial links" between the companies, they were insufficient to establish the level of integration needed for the existence of a unitary business. *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 368 (1982).

Contrary to the commissioner's assertions, General Mills did not, either directly or through the SRG, involve

itself in the operational management of either subsidiary or establish business guidelines for them. Although nine officers and directors served both General Mills and Eddie Bauer at different times during portions of the corporate fiscal years ending May, 1976, 1977, 1988, and 1989, the uncontroverted evidence was that they did not participate in the day-to-day management of Eddie Bauer or interject themselves into the business decisions of its management. See *id.* at 368-369 (sporadic participation of common directors at board meetings insufficient to establish unitary relationship). The SRG did not direct the management of Eddie Bauer or Talbots to do anything. It was not involved in the day-to-day management of either subsidiary and it did not oversee any of their operations. *Id.* The primary purpose of the SRG was to provide administrative support to the subsidiaries and coordinate their requests for major capital funding for review by General Mills. The board found that the benefits that the subsidiaries received from the SRG were minimal, and that they bore the cost of the services provided to them. Contrast *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 180 n.19. After Eddie Bauer and Talbots were both sold, most employees of the SRG lost their jobs precisely because they were not part of General Mills's management team; and the senior management staff of Eddie Bauer remained with Eddie Bauer after the sale. The economic "performance targets" that General Mills set for the subsidiaries were not operational guidelines that dictated the internal workings of the subsidiaries, but instead were the type of performance demands that the sole shareholder of any business corporation would make in overseeing its investment. Such evidence does not compel a finding that a unitary relationship existed. See *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 369. The key

issues and corporate strategies needed to attain those levels of performance were determined autonomously by management of the subsidiaries, persuasive evidence that Eddie Bauer and Talbots operated independently of General Mills and that no centralized management existed between them. See *id.* at 364-365.

The commissioner correctly observes that "mere decentralization of day-to-day management responsibility and accountability cannot defeat a unitary business finding," *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 180 n.19, citing *Exxon Corp.* v. *Department of Revenue of Wis., supra* at 224. However, it is also true that "a unitary business finding could not be based merely on 'the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary.'" *Container Corp. of Am.* v. *Franchise Tax Bd., supra,* quoting *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 369. "The difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 180 n.19. "[T]he proper inquiry looks to 'the underlying unity or diversity of business enterprise,' [*Mobil Oil Corp.* v. *Commissioner of Taxes, supra* at 440], not to whether the nondomiciliary parent derives some economic benefit – as it virtually always will – from its ownership of stock in another corporation. [*ASARCO Inc.* v. *Idaho State Tax Comm'n, supra* at 325-329]." *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 363-364. There is no evidence that General Mills interjected its operational expertise of the wholesale food industry into the management of Eddie Bauer, a business oriented toward retail

sales of sports clothing and sporting goods. Similarly, there is no evidence that General Mills imposed the over-all operational strategy used in its wholesale food business onto Eddie Bauer. There is, as discussed above, sufficient evidence to support the board's findings that there was no centralized management between General Mills and its subsidiaries.

The commissioner next contends that the board misapplied the "functional integration" and "economies of scale" tests, arguing that under *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 178, the "ultimate issue is whether there was a 'flow of value' between General Mills and [Eddie] Bauer." His understanding of *Container Corp.* is flawed. The commissioner's approach would produce a unitary business finding in virtually every case, as there will almost always be some flow of value through unity of ownership. His approach has been rejected by the Supreme Court. See *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 178-179; *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 363-364; *ASARCO Inc.* v. *Idaho State Tax Comm'n, supra* at 325-328. Although there must be a "flow of value," there also must be some "underlying unity . . . of business enterprise," *Mobil Oil Corp.* v. *Commissioner of Taxes, supra* at 440, some "substantial mutual interdependence," *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 371. See *Container Corp. of Am.* v. *Franchise Tax Bd., supra.*

The "flow of value" on which the commissioner relies, namely, the ability of Eddie Bauer to borrow funds from General Mills on an as-needed basis and the cost-free

provision of cash management services, either does not arise from a unity of business enterprise or is unsupported by the record.[5] All loans to the subsidiaries were arm's-length transactions at commercial rates; and, except for absorbing the entire cost of preparing the consolidated tax returns required by the SEC and the New York Stock Exchange, General Mills charged Eddie Bauer for the cost of all services provided. These facts do not support a finding that the businesses were functionally integrated. See *W.R. Grace & Co.-Conn.* v. *Commissioner of Revenue,* 58 Mass. App. Ct. 469, 476 (2003). There is no evidence that these transactions served an operational function of General Mills. Rather, the transactions are consistent with the existence of an investment function. Contrast *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 180 n.19. Where, as here, a parent invests in a subsidiary that engages in a business truly distinct from that of the parent, it is less likely that the two enterprises will coordinate functions by operational integration, sharing expertise, or economies of scale. See *id.* at 178. The record does not support the commissioner's claim that Eddie Bauer received cash management services from General Mills, or that such services were provided to Eddie Bauer on a cost-free basis. The record does support the board's finding that the few services that General Mills did

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[5] The commissioner does not argue that the capital transaction here was taxable because General Mills intended it to be a source of working capital and was therefore an operational function of General Mills's unitary business rather than a passive investment unrelated to its multi-State business in Massachusetts. See *Allied-Signal, Inc.* v. *Director, Div. of Taxation,* 504 U.S. 768, 787 (1992); *Container Corp. of Am.* v. *Franchise Tax Bd.,* 463 U.S. 159, 180 n.19 (1983).

provide to Eddie Bauer served an investment function, not an operational function. See *id.* at 180 n.19.

Finally, the commissioner argues that General Mills held itself out in its combined annual reports as having actual control over the operations of Eddie Bauer, and that such statements are sufficient to establish a unitary relationship. See *Becton, Dickinson & Co.* v. *Department of Revenue*, 383 Mass. 786, 789 (1981). The board declined to make such a finding, citing *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 369 (publication of "annual reports . . . on a consolidated basis" alone is not controlling). Moreover, the annual reports do not compel such a finding, but rather suggest that General Mills simply was describing itself as a holding company and that Eddie Bauer was but one of many companies that it owned.

The evidence is sufficient to support the board's findings that Eddie Bauer was acquired by General Mills as an investment and treated as such, that it was not operationally integrated into General Mills's wholesale food business but instead operated as an independent business, and that General Mills's occasional involvement in the management of Eddie Bauer was "more akin to [that of] a parent company's oversight of its investment in a subsidiary." See *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M., supra* at 369 ("Except for the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of these . . . corporations"); *Container Corp. of Am.* v. *Franchise Tax Bd., supra* at 166 (there must be "some

sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation"). The board did not commit an error of law in deciding that there was no unitary business relationship between General Mills and Eddie Bauer, and we will not disturb that decision.

3. *Sale of the Talbots stock.* General Mills and Talbots argue that the election under I.R.C. § 338(h)(10) to treat the sale of Talbots's stock as a sale of its assets for Federal tax purposes is a "fiction" that should not control the Massachusetts determination of gross income under G. L. c. 63, § 30,[6] and that Massachusetts does not recognize the election under § 338(h)(10).[7, 8] They concede that "[g]enerally, a corporation's Massachusetts income, with certain exceptions, starts with its [F]ederal taxable

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[6] "Gross income" is "gross income as defined under the provisions of the Federal Internal Revenue Code, as amended and in effect for the taxable year," with certain adjustments not relevant here. G. L. c. 63, § 30(3).

[7] General Mills and Talbots argued before the board that "[t]he § 338(h)(10) election does not confer jurisdiction to tax where none exists," and that the tax on the deemed sale of assets was a violation of the due process clause of the Federal Constitution. They have not argued this issue on appeal, and it is deemed waived. See Mass. R. A. P. 16(a)(4), as amended, 367 Mass. 921 (1975); *Boston Hous. Auth.* v. *Guirola,* 410 Mass. 820, 827 n.9 (1991).

[8] The commissioner argues that General Mills and Talbots have raised their statutory claim for the first time on appeal, and that we should disregard it. See G. L. c. 58A, § 13; *Gillette Co.* v. *Commissioner of Revenue,* 425 Mass. 670, 684 (1997). We are satisfied that the issue was raised in the petition to the board. Moreover, the board addressed the statutory issue in its decision. The issue has been preserved for appellate review.

income." See *PMAG, Inc.* v. *Commissioner of Revenue,* 429 Mass. 35, 39 (1999). They rely on *Rohrbough, Inc.* v. *Commissioner of Revenue,* 385 Mass. 830, 832 (1982), where the court said: "Although the figure shown as gross income on a taxpayer's Federal return will normally be the gross income for State tax purposes for the same tax year, *this is not always the case*" (emphasis added), and Weston Marketing Corp. *vs.* Commissioner of Revenue, Appellate Tax Board No. 161893 (1994), aff'd, 40 Mass. App. Ct. 1108 (1996), which they describe as "another instance in which Massachusetts gross income was different from [F]ederal gross income because of a fictional transaction prescribed by [F]ederal tax law."[9] However, neither case holds that a "fictional" treatment of gross income prescribed by Federal tax law may not be used to determine gross income for Massachusetts tax purposes, or that Massachusetts does not recognize the particular "fictional" treatment of gross income under I.R.C. § 338(h)(10).

In the *Rohrbough* case the court was presented with a differential treatment of income for Federal and State purposes that had been brought about by an election under Massachusetts law. George I. Rohrbough realized a substantial gain in 1971 from the sale of real estate in Boston. The sales price was to be paid over six years,

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[9] General Mills and Talbots also rely on Combustion Eng'g, Inc. *vs.* Commissioner of Revenue, Appellate Tax Board No. F228740 (2000). In that case the parent corporation reported the gain from the deemed sale of its subsidiary's assets as the income of the subsidiary, and did not litigate the issue that is now before us. The board agreed, without discussion, that the income from the deemed sale was properly attributed to the subsidiary. That decision, therefore, does not provide guidance.

pursuant to promissory notes. The transaction qualified for treatment as an instalment sale under I.R.C. § 453, 26 U.S.C. § 453 (1976). The Federal tax was thereby spread out over six years, as each note matured. Rohrbough elected, pursuant to G. L. c. 62, § 63 (*e*), to pay the Massachusetts tax on the entire gain with his 1971 Massachusetts individual tax return. In 1974, he transferred the remaining instalment notes for all the shares of stock of Rohrbough, Inc., a transaction that qualified as a tax free exchange under I.R.C. § 351, 26 U.S.C. § 351 (1966). Thereafter, the corporation received instalment payments that it reported on its Federal returns. It did not report the payments on its Massachusetts returns because Rohrbough had paid the Massachusetts income tax due on the entire gain with his 1971 individual return. The commissioner assessed a tax on these payments and denied the corporation's applications for abatement. The corporation appealed to the board, which ruled that it was entitled to the abatements. *Rohrbough, Inc.* v. *Commissioner of Revenue, supra* at 830-831. The court affirmed the decision of the board, holding that where the State tax on the gain had been fully paid in 1971 pursuant to an election under G. L. c. 62, § 63(*e*), the commissioner could not impose what amounted to a double tax on the gain. *Id.* at 831. The court construed the reference to gross income in G. L. c. 63, § 30, as a reference "to the provisions of the Internal Revenue Code and not simply to the amount of gross income shown on a taxpayer's Federal income tax return for the same tax year." *Id.* at 832. The original differential treatment of the gain by Rohrbough for Federal and State purposes was specifically permitted by G. L. c. 62, § 63(*e*), and the court applied various provisions of the Internal Revenue Code to preserve that treatment for his successor in interest.

Weston Marketing Corp. *vs.* Commissioner of Revenue, *supra,* is similar, but the differential treatment of income in that case was, by statute, mandatory, and amounted to nonrecognition of income. In that case the taxpayer was a corporation that had elected Subchapter S status for Federal tax purposes. It had acquired certain regulated futures contracts on which it was required, pursuant to I.R.C. § 1256, 26 U.S.C. § 1256 (1981), to recognize any gain or loss at market value on the last day of the year. On December 31, 1981, the aggregate market value of the taxpayer's futures contracts was less than its cost, and pursuant to § 1256, it reported a loss on its Federal tax return. However, it was not permitted to take the loss on its Massachusetts return because Massachusetts did not recognize Subchapter S corporations at the time. See G. L. c. 62, § 2, as appearing in St. 1973, c. 723, § 2.[10] In 1982 the taxpayer sold some of its futures contracts and reported a gain on its 1982 Federal return that reflected a recapture of the loss reported on its 1981 Federal return. It also reported a gain on its 1982 Massachusetts return, but that gain did not include the recaptured loss from 1981 because the taxpayer could not and did not claim the loss on its 1981 Massachusetts return. The board rejected the commissioner's argument that, as matter of law, a taxpayer's Massachusetts gross income will be the same as the amount shown on its Federal return. It ruled instead that it must look to the provisions

[10] The income and loss pass-through features available to Subchapter S corporations for Federal tax purposes were expressly not recognized in Massachusetts until 1986, four years after the sale in question. See St. 1986, c. 488, §§ 72, 74. See also *Koch* v. *Commissioner of Revenue,* 416 Mass. 540, 551 (1993).

of the Internal Revenue Code to determine a taxpayer's gross income, citing *Rohrbough, Inc.* v. *Commissioner of Revenue, supra.* The board noted that I.R.C. § 111(a), 26 U.S.C. § 111(a) (1980), in effect at the time, excluded from gross income "income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed." Weston Marketing Corp. *vs.* Commissioner of Revenue, *supra* at 6. It concluded that where the taxpayer appellant "did not have the benefit of the loss for Massachusetts purposes, there is no logical or statutory basis for recapturing that loss for Massachusetts purposes." *Id.*

There is no merit to the claim that Massachusetts does not recognize the election under I.R.C. § 338(h)(10). General Laws c. 63, § 30, operates to include all gross income determined under the Internal Revenue Code, except income that is expressly excluded. There is no statute that denies recognition of an election under § 338(h)(10) or otherwise excludes income resulting from such an election from the application of G. L. c. 63, § 30. See *Koch* v. *Commissioner of Revenue,* 416 Mass. 540, 551 (1993); Weston Marketing Corp. *vs.* Commissioner of Revenue, *supra.* The election is therefore recognized. Similarly, differential treatment of income requires specific statutory authority, as in *Rohrbough,* and General Mills and Talbots cite no statute that permits or requires differential treatment of Talbots's Federal and State gross income. We also note that neither General Mills nor Talbots has been exposed to double taxation, as was the taxpayer in *Rohrbough,* nor has either been assessed a tax on a benefit that was not received, as occurred in the Weston Marketing case.

We are not persuaded that the gain resulting from the "fiction" should not be taxed because it produced no income in Massachusetts. A gain actually was realized from the sale of the Talbots stock. Had Talbots actually sold its assets, there can be no doubt that the gain would have been taxable in Massachusetts. The "fiction" created by I.R.C. § 338(h)(10) simply allowed the parties to change the means by which the gain was realized and by whom. It permitted General Mills and Talbots to elect which of them would report that gain on its portion of their consolidated Federal return. Because they elected to have Talbots report the gain, the gross income on Talbots's Federal tax return increased by the amount of the gain, precisely as if it had sold its assets and produced income in Massachusetts; and General Mills's gross income was correspondingly reduced, as if it had never sold its Talbots stock. There was nothing "fictional" about the effect of the election for Federal tax purposes. Talbots became liable for a Federal tax on the gain. Moreover, the tax would not simply be the same amount that General Mills would have paid had the election not been made. As a result of the election, General Mills effectively dropped out of the picture, and the tax would be based on Talbots's separate return, which amounted to approximately $3 million more than General Mills would have paid. Those nonfictional consequences had been anticipated and adjustments were made during negotiations between General Mills and JCL. The election also produced Massachusetts tax consequences consistent with the Federal treatment of the gain. See *Dow Chem. Co.* v. *Commissioner of Revenue,* 378 Mass. 254, 264 (1979). There is no suggestion that this approach will cause confusion among the States and lead to double taxation. Because § 338(h)(10) treated the gain from the deemed sale of Talbots's assets as includable in its Federal

gross income, the literal wording of G. L. c. 63, § 30, requires that it also be included in Talbots's Massachusetts gross income. See *id.* The board correctly determined that the gain from the deemed sale was includable in Talbots's Massachusetts gross income.[11]

4. *Sale of intangibles.* The board found that "the creation of Tal HC, the transfer of Talbots' intangibles and the subsequent sale by Tal HC, lacked economic substance . . . beyond the mere creation of tax benefits." It applied the "step transaction doctrine" and concluded that "[n]otwithstanding the form of the transaction, its substance was the direct sale of the intangibles by Talbots." General Mills and Talbots argue that the board's decision is not supported by the record, and that the transaction had a valid business purpose and economic substance beyond the creation of tax benefits. They contend that the transaction was in furtherance of General Mills's over-all business purpose to sell the Talbots stock, that JCL structured the transaction in a manner that would transfer the trademarks to a foreign affiliate in order to obtain

[11] General Mills and Talbots submitted a postargument letter pursuant to Mass. R.A.P. 16(*l*), as amended, 386 Mass. 1247 (1982), citing supplemental authorities, *Canteen Corp.* v. *Commonwealth*, 792 A.2d 14 (Pa. Commw. Ct. 2002), and Osram Sylvania, Inc. *vs.* Commonwealth, No. 310 F.R. 1998 (Pa. Commw. Ct. Mar. 6, 2003). These cases do not support their claim. The question before the court was whether the gain from a deemed sale of assets pursuant to an election under I.R.C. § 338(h)(10) was taxable as business income or nonbusiness income under Pennsylvania law. Nonbusiness income is taxed at a lower rate. The subsidiary had reported the gain from the deemed sale as nonbusiness income on its return. The court concluded that the gain was taxable as nonbusiness income. Apropos to this case, the gain was both reportable by and taxable to the subsidiary.

certain advantages in the international market and advantages under certain international accounting practices, and that pursuant to the terms of the purchase and sale agreement General Mills was required to accommodate JCL.

The step transaction doctrine is a rule that, for purposes of taxation, looks to the substance of a transaction over its form. See *Commissioner of Revenue* v. *Dupee,* 423 Mass. 617, 624 (1996), quoting 11 Mertens, Federal Income Taxation § 43.253, at 347 (1995). It "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." *Penrod* v. *Commissioner,* 88 T.C. 1415, 1428 (1987). See *Commissioner of Internal Revenue* v. *Court Holding Co.,* 324 U.S. 331, 334 (1945) ("The incidence of taxation depends upon the substance of a transaction. . . . A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title"); *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path"). "Thus, the substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes." *Commissioner of Revenue* v. *Dupee, supra,* quoting Rev. Rul. 79-250, 1979-2 C.B. 156.

There was ample evidence to support the board's findings. JCL's initial modification called for Talbots to sell its intangibles directly to Jusco (Europe). After General Mills expressed concern about the Massachusetts tax

consequences, JCL proposed the two-step transaction that would satisfy the needs of both parties: Jusco (Europe) would acquire the Talbots intangibles, and General Mills would not have to pay a Massachusetts tax. The intermediate transaction served no legitimate business purpose and was designed solely to avoid a Massachusetts tax. It is immaterial that the end result may have been for legitimate business purposes. If an intermediate step has no legitimate business purpose beyond tax avoidance, it may be collapsed for tax purposes under the step transaction doctrine. Tal HC was merely a conduit through which the legitimate transactional route passed, and its involvement was properly compressed into a single sale of the Talbots intangibles directly to Jusco (Europe).

General Mills and Talbots contend that Tal HC was not just a paper entity with no employees or offices. There was evidence, however, that such was the case, and that the original plan was to liquidate Tal HC shortly after it sold the intangibles. The finding of the board on this point is thus final, and one that we cannot disturb. But even if Tal HC were a functioning business, the result would not change because the over-all nature of the intermediate step is what matters, not just the nature of the intermediary, although that may be relevant, as here. Application of the step transaction doctrine is not limited to paper entities, and General Mills and Talbots cite no authority to the contrary. It is significant that the licensing agreement between Talbots and Tal HC did not require Talbots to make any royalty payments, but that the licensing agreement between Talbots and Jusco (Europe) did. This is persuasive evidence that Tal HC had no legitimate role in the sale other than tax avoidance.

General Mills and Talbots also argue that if the sale of Talbots's intangibles is to be compressed by application of the step transaction doctrine, then the entire plan must be reduced to a single transaction for the sale of the Talbots stock.[12] They ignore the fact that the parties structured their agreement as two separate transactions. If we were to grant the relief that General Mills and Talbots seek, we would be changing the basic nature of that agreement. JCL did not agree to a simple sale of stock; it agreed to buy assets. The parties agreed to two separate transactions: one for the sale of stock (subject to an election under § 338[h][10]), and one for the sale of intangibles. And so it was that two separate transactions involving four distinct corporations were presented to the Federal government for taxation: one, a deemed sale of assets by Talbots to Jusco (U.S.A.); the other, a sale of intangibles by Tal HC to Jusco (Europe). It is significant that Talbots and Tal HC paid Federal taxes on a total reported gain of $425 million from the two transactions, and JCL received a stepped up basis of $425 million in the assets it acquired. See I.R.C. § 338(h)(10); Letter Ruling 84-45, 3 Official MassTax Guide at 816-817 (West 2003) (Massachusetts affords stepped-up basis from election under I.R.C. § 338[h][10]). The step transaction doctrine was correctly applied to straighten the circuitous route taken in the second transaction, allowing the Commonwealth to assess a tax on the true nature of that transaction, namely, a sale of intangibles by Talbots to Jusco (Europe), while leaving the overall agreement intact.

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[12] The commissioner argues that this issue was not raised below, but we are satisfied that it was. See note 8, *supra*.

5. *Tax on sale of intangibles.* Under Massachusetts law, a corporation's taxable net income is multiplied by a three-factor apportionment formula to determine the percentage of the income that is taxable in Massachusetts. See G. L. c. 63, § 38(*c*) (taxable net income apportioned to Commonwealth by multiplying such income "by a fraction, the numerator of which is the property factor plus the payroll factor plus twice times the sales factor, and the denominator of which is four"). See *Gillette Co.* v. *Commissioner of Revenue,* 425 Mass. 670, 673 (1997). The board determined that the commissioner properly included the receipts from Talbots's sale of its intangibles in the numerator of Talbots's sales factor, which is determined pursuant to G. L. c. 63, § 38(*f*).[13] As part of that determination the board concluded that, pursuant to § 38(*f*)(2), "a greater portion of the intangibles' income-producing activity was performed in the Commonwealth than in any other [S]tate, based on cost of performance." The board based its conclusion on findings that it was the business operations (including billing and customer relations) and management of Talbots, all of which were located in Massachusetts, that produced most of the value of the

[13] General Laws c. 63, § 38(*f*), states: "The sales factor is a fraction, the numerator of which is the total sales of the corporation in this commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in this subsection, 'sales' means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities. . . . Sales [of intangible] personal property, are in this commonwealth if: . . . 2. the income-producing activity is performed both in and outside this commonwealth and a greater proportion of this income-producing activity is performed in this commonwealth than in any other state, based on costs of performance."

intangibles. The board also noted that all orders for goods were sent to and filled from Talbots's distribution centers, all of which were located in Massachusetts.

General Mills and Talbots first argue that the board's recent decision in Combustion Eng'g, Inc. *vs.* Commissioner of Revenue, Appellate Tax Board No. F228740 (2000), requires that the sale of intangibles be excluded from the numerator of Talbots's sales factor. The Combustion Engineering case has no relevance to the issue at hand. In that case the board ruled that the proceeds from a deemed sale of assets following an election under I.R.C. § 338(h)(10) could not be included in the sales factor because the sales in question actually were a sale of stock, the proceeds of which are specifically excluded from the sales factor pursuant to G. L. c. 63, § 38(*f*). Here, the sale did not involve a sale of stock, but a sale of Talbots's trademarks and trade names, which are not excluded from the sales factor.

There is no merit to the argument that all the income-producing activity occurred outside Massachusetts, either in Virginia, where a major portion of Talbots's catalogs were printed, or in New York and Minnesota, where the sale was negotiated. Such reasoning trivializes the years of work and business effort that developed the value of Talbots's intangibles, and the argument ignores the undisputed evidence, which the board accepted, that at each step of the catalog development process it was Talbots's management and employees, located in Massachusetts, who were responsible for the decision-making in preparing and finalizing the catalog and contributed most to the value of the intangibles. The board properly rejected the argument.

Finally, General Mills and Talbots argue that the effect of placing the receipts from the sale of intangibles in the numerator of Talbots's sales factor together with only one month of regular sales from the relevant fiscal year grossly distorted its actual business activity in Massachusetts and thereby resulted in an extraterritorial tax in violation of the due process and commerce clauses. In order to prevail on their constitutional challenge they have the "distinct burden of showing by 'clear and cogent evidence' that [the State tax] results in extraterritorial values being taxed." *Container Corp. of Am.* v. *Franchise Tax Bd.*, 463 U.S. 159, 164 (1983), quoting *Exxon Corp.* v. *Department of Revenue of Wis.*, 447 U.S. 207, 223 (1980). It is uncertain how inclusion of the receipts from the sale of the intangibles would result in an extraterritorial tax. The Commonwealth's apportionment formula need only produce "a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'" *Id.* at 223, quoting *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978). The argument is speculative, and must be rejected. See *Becton, Dickinson & Co.* v. *Department of Revenue*, 383 Mass. 786, 770 (1981).

The decision of the Appellate Tax Board is affirmed.

So ordered.

APPENDIX B

COMMONWEALTH OF MASSACHUSETTS

SUPREME JUDICIAL COURT FOR THE COMMONWEALTH

ORDER

It is hereby Ordered, that the following appeal, now pending in the Appeals Court, be transferred, sua sponte, to the Supreme Judicial Court for the Commonwealth:

Appeals Court No. 2001-P-1335

GENERAL MILLS, INC. & others
vs.
COMMISSIONER OF REVENUE

The provisions of Massachusetts Rules of Appellate Procedure, Rule 11(g), are applicable to the filing of briefs.

By the Court,

/s/ Susan Mellen
Susan Mellen, Clerk

ENTERED: December 20, 2002

APPENDIX C

THE COMMONWEALTH OF MASSACHUSETTS

[LOGO] ***Appellate Tax Board***

Leverett Saltonstall Building, Government Center
100 Cambridge Street
Boston, Massachusetts 02202

Docket No. F223398

GENERAL MILLS & SUBSIDIARIES,

Appellant.

COMMISSIONER OF REVENUE,

Appellee.

DECISION

The decision is for the appellant on the unitary business status of Eddie Bauer, Inc. Following the Rule 33 Computation Hearing held as a result of the Board's order of August 19, 1999, the Board has determined that an abatement be granted in the amount of $634,077 of tax plus statutory additions.

APPELLATE TAX BOARD

By /s/ Kenneth W. Gurge Chairman.
/s/ Frank Scharaffa Member.
/s/ Abigail A. Burns Member.
/s/ Donald E. Gorton III Member.
/s/ [Illegible] Member.
Attest: /s/ [Illegible] Clerk.

Date: OCT 7 1999
(Seal)

NOTICE: An appeal may be taken to the Massachusetts Appeals Court by either party to these proceedings. A claim of appeal should be filed with this Board in accordance with the Massachusetts Rules of Appellate Procedure.

APPENDIX D

COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

GENERAL MILLS, INC. and SUBSIDIARIES v. **COMMISSIONER OF REVENUE**

Docket No. F223398

Promulgated:
June 29, 2001

This an appeal under the formal procedure pursuant to G.L. c. 62C, § 39, from the refusal of the Commissioner of Revenue to abate corporate excise assessed to General Mills, Inc. for the taxable period ending May 31, 1989.

Former Chairman Gurge heard the appeal and was joined in the decision for the appellant by current Chairman Burns and Commissioners Scharaffa, Gorton and Egan.

These findings of fact and report are made pursuant to a request by both parties under G.L. c. 58A, § 13, and 831 CMR 1.32.

Edward F. Hines, Jr., Esq. and *Kathleen King Parker*, Esq., for the appellant.

Thomas K. Condon, Esq. and *Michael T. Fatale*, Esq., for the appellee.

FINDINGS OF FACT AND REPORT

Based on the testimony and exhibits offered at hearing, the Appellate Tax Board ("Board") made the following findings of fact.

The present appeal resulted from the sale by General Mills, Inc. ("General Mills") of its 100% stock interest in The Talbots, Inc. ("Talbots"); a domestic corporation with its headquarters located in Hingham, Massachusetts, and its interest in Eddie Bauer, Inc. ("Eddie Bauer"), a foreign corporation with its headquarters located in Seattle, Washington.

On June 27, 1988, General Mills sold its stock interest in Talbots. The purchaser of the stock, Jusco, Ltd. ("Jusco"), elected under § 338(h)(10) of the Internal Revenue Code ("Code") to treat this sale, for federal income tax purposes, as a sale of Talbots' assets. Because of the election, Talbots recognized a gain on the "deemed sale" of its assets. Correspondingly, General Mills did not recognize a gain on the sale of the Talbots' stock. Shortly thereafter, on July 2, 1988, General Mills sold its stock interest in Eddie Bauer. No § 338(h)(10) election was made.

Prior to General Mills' disposition of the Talbots stock, Talbots created a wholly-owned subsidiary, TalHC, Inc. ("TalHC") to which Talbots transferred the rights to its trademarks and tradenames. TalHC then sold these trademarks to Jusco Europe B.V. ("Jusco B.V."), a subsidiary of Jusco.

On or about February 15, 1990, General Mills filed its fiscal year 1989, period ending May 31, 1989, Combined Foreign Business Corporate Excise Return with its subsidiaries and paid the tax shown due thereon.[1] On its

[1] General Mills filed the combined return with its subsidiaries Eddie Bauer, York Steak House, General Mills Restaurants, General Mills Finance and Talbots, for the period ending May 31, 1989.

return, General Mills: (1) excluded from its net income the gain recognized from the sale of both the Talbots and the Eddie Bauer stock; (2) included, in Talbots' income column, the gain recognized from the "deemed sale" of Talbots' assets attributable to the § 338(h)(10) election; (3) excluded from Talbots' net income the gain recognized from the sale of its intangibles; and (4) excluded, in computing Talbots' "sales factor," the proceeds from the sale of its intangibles.

On February 7, 1992, the Commissioner assessed additional taxes in the amount of $10,926,436, plus statutory additions. On July 22, 1992, General Mills timely filed its Application for Abatement together with an agreement to extend the time within which the Commissioner could act on the abatement request. By notice dated August 18, 1994, the Commissioner notified General Mills that it had granted a partial abatement. On September 22, 1994, General Mills timely filed its appeal with this Board. On this basis, the Board found that it had jurisdiction over this appeal.

The five issues raised by General Mills' appeal are: (1) whether the Commissioner's assessment was procedurally correct; (2) whether General Mills' recognized gain, from the sale of its Eddie Bauer and Talbots stock, is includible in General Mills' taxable income subject to apportionment as part of General Mills' unitary business; (3) whether the deemed sale of Talbots' assets, pursuant to Jusco's § 338(h)(10) election, allowed the gain recognized from the deemed sale to be included in Talbots' Massachusetts taxable income; (4) whether the gain recognized on the sale of Talbots' intangibles was properly includible in Talbots' taxable income; and, if so, (5) whether the recognized gain on the sale of the intangibles was includible in

the numerator of Talbots' "sales factor," for purposes of apportioning its income to Massachusetts.

I. Assessment

By a Notice of Intention Assess ("NIA") dated January 7, 1992, the Commissioner notified General Mills that he intended to assess additional taxes, plus interest and penalties, the total amount of $15,809,545. The NIA included assessments for calendar years 1988 and 1990, not at issue in the present appeal. The proposed assessment for fiscal year 1989 was $10,865,588, plus interest and penalties. On or about February 5, 1992, General Mills submitted two checks to the Commissioner, totaling $15,809,545, the full amount shown due on the NIA including fiscal years 1988 and 1990. By letter dated February 5, 1992, General Mills acknowledged that the payment was "remitted [for] the additional tax and interest assessed due to a Massachusetts field audit."

On February 7, 1992, more than thirty days after the Commissioner issued the NIA, the Commissioner produced a second NIA with the notation Instruction to Bill, signed by the Commissioner's representative ("Instruction to Bill") which showed the full assessment amount of $15,809,545. The Instruction to Bill also reflected General Mills' full payment. Subsequently, on March 6, 1992, the Commissioner issued Notice of Assessment ("NOA") showing a zero balance due for fiscal year 1989. The NOA showed an assessment, for the period at issue in this appeal, of only $865,588, in contrast to the $10,865,588 figure shown on the NIA and the Instruction to Bill, and also reflected a payment of only $5,752,491 despite the fact that General Mills had paid more than $15 million.

On August 5, 1992, General Mills timely filed its Application for Abatement with the Commissioner seeking an abatement of $13,937,671, plus interest. The abatement application reflected the assessment of $10,865,588, and sought a refund of these taxes in addition to taxes attributable to the deemed sale of Talbot's assets as reported on General Mills' tax return.[2] On August 8, 1992, the Commissioner issued a second NOA which, like the March 6th NOA, erroneously reflected a tax assessment of only $865,588.

On August 18, 1994, the Commissioner granted General Mills a partial abatement. Subsequently, on September 21, 1994, General Mills timely filed this appeal with the Board. In its appeal, General Mills for the first time included a claim that the Commissioner failed to follow the proper procedures in assessing $10,000,000 of the adjustments made pursuant to the audit. Upon notification of the discrepancy between the NOAs and the NIA and Instruction to Bill, the Commissioner issued a corrected NOA for fiscal year 1989 in the full amount of $10,865,588, plus interest when it filed its Answer with the Board.

At the hearing, Edward Lapore testified for the Commissioner to support the Commissioner's contention that the assessment was procedurally correct and that a valid assessment had been made for the full amount of $10,865,588 in tax. During the period at issue in this

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[2] Although appellant included, in Talbots' income column, the gain recognized on the deemed sale of Talbots' assets, the appellant now argues that no portion of the gain should have been included in either Talbots' or General Mills' Massachusetts taxable income.

appeal, Mr. Lapore worked in the Mass. Tax Bureau. His primary function was to "peruse all reports, data, and maintain the integrity of the data base." Mr. Lapore explained that in the fall of 1988, the Department of Revenue ("Department") converted its computer system to the Mass. Tax system and with this transition problems arose. Among those problems was that NOAs omitted figures in the "tens of millions" column.

Mr. Lapore testified that in the summer of 1996, he examined the Department's records relative to the General Mills assessment. Mr. Lapore explained that the NOA, which showed a tax assessment of $865,588 and not the $10,865,588 amount proposed to be assessed in the NIA and assessed by the Instruction to Bill, was simply due to the truncation issue explained above. He further explained that the Instruction to Bill, dated February 7, 1992, showed full payment by General Mills on February 5, 1992 in the amount of 15,809,544. This same document had the requisite signature of the Commissioner's representative and constituted the Commissioner's deficiency assessment. Based on these documents together with the Mass. Tax computer records, Mr. Lapore concluded that an audit assessment was in fact made in the amount of $10,865,588, prior to the issuance of the NOAs.

Based on the evidence presented, the Board found that there was substantial credible evidence that an assessment was made in the amount of $10,865,588 on February 7, 1992, as evidenced by the Instruction to Bill. Accordingly, the Board found that the Commissioner's assessment of additional taxes in the amount of $10,865,588 was procedurally correct.

II. Gain on sale of Eddies Bauer and Talbots' stock – Unitary Business Analysis

General Mills is a multi-faceted corporation, incorporated in Delaware, with its headquarters in Minneapolis, Minnesota. General Mills is primarily engaged in producing and selling packaged food products at the wholesale level.

Mr. Clifford Whitehill-Yarza ("Mr. Whitehill") testified on behalf of General Mills. Mr. Whitehill was employed by General Mills from 1963 until 1995. When Mr. Whitehill first started with the company, General Mills was principally engaged in the packaged-foods business, primarily cake mixes and cereals. Mr. Whitehill explained that in the early 1970s, General Mills began to divest its flour mills and reduce its presence in the commercial flour business while expanding into other lines of business.

During this time of expansion, Mr. Whitehill was the assistant general counsel and assistant secretary of General Mills. His primary responsibility was to handle the company's acquisitions. At its peak, General Mills had five lines of business: packaged foods, restaurants, toys, fashion and specialty retailing. The only line of business which was conducted directly by General Mills was the packaged-foods business. With respect to the remaining lines of business, General Mill considered itself merely a holding company.

In 1971, General Mills purchased 100% of the stock of Eddie Bauer, a sporting goods and sporting clothing business. At the time it was purchased, Eddie Bauer operated primarily through mail-order catalogs. It had only one retail outlet. In 1973, General Mills purchased a 100% interest in Talbots, a clothing retailer and catalog

sales company. From the time of the acquisitions until the companies were sold in 1988, senior management for Eddie Bauer was located in Seattle, Washington and Talbots' senior management was located in Hingham, Massachusetts.

Each subsidiary had its own employees. Payroll, employee training and employee benefits were all handled at the local level by each of the subsidiaries' senior management. Each line of business would determine which benefits were appropriate for that particular industry and then the senior management would devise the appropriate plan. On occasion, a General Mills employee would transfer to a subsidiary. Typically, if a subsidiary had a vacancy it would be posted and a General Mills employee, if qualified, would fill the position. No transfers were forcibly imposed on General Mills' employees.

Purchasing, inventory, marketing, site selection and research were all also handled at the subsidiary level. Both Talbots and Eddie Bauer maintained their own administrative offices, warehouses and retail stores, none of which was shared with General Mills or with one another. Neither Eddie Bauer nor Talbots joined together or with General Mills in making purchases nor were there purchases or sales between the companies.[3]

Each of the subsidiaries' senior management was responsible for developing and implementing their respective budgets. Although the budgets were provided to

[3] Mr. Whitehill noted that on occasion an incidental number of items may have been sold by Eddie Bauer to General Mills to be used by General Mills for promotional purposes.

General Mills for review, this submission was done merely to keep General Mills abrest of its investments. Each subsidiary was responsible for its internal auditing and then passing that information on to General Mills. Overall, the day-to-day management of the subsidiaries rested with their respective senior management.

Although Eddie Bauer and Talbots were operated as independent and autonomous businesses, General Mills did provide some services to its subsidiaries. From time to time, General Mills would provide financing to its subsidiaries, charging interest at a commercial rate. When required by a prospective landlord, General Mills would guarantee a lease for its subsidiaries. Also, General Mills would guarantee revenue bonds, which were issued to finance major capital projects undertaken by the subsidiaries.

General Mills also provided its subsidiaries with legal and tax services. However, the subsidiaries were charged a fee for the legal services. The fee was calculated by taking the law department's yearly budget, dividing it by the total number of hours of service provided to the entire corporation, and multiplying by the number of hours dedicated to the specific subsidiary.

The tax services, for which no fee was charged, were provided for several reasons. First and foremost, the New York Stock Exchange and the Securities and Exchange Commission required that wholly-owned subsidiaries file their returns on a consolidated basis with the parent corporation. As such, it was more efficient and practical for a single tax department to determine the tax liabilities of all entities and file the necessary returns. For the same

reasons, General Mills and its subsidiaries used the same auditors.

Mr. Whitehill noted that it was not uncommon for a General Mills officer or member of the board of directors, to also be a member of the subsidiaries' board of directors. He further explained, however, that the subsidiaries' board of directors had no involvement in the day-to-day operations of the companies. Instead, the subsidiaries' senior management handled these functions. Likewise, the General Mills board of directors had no involvement in the day-to-day operations of the subsidiaries. Their involvement was limited to those occasions when the subsidiary required major capital expenditures. In those instances, approval from the General Mills board of directors was required.

During the years that General Mills owned Eddie Bauer and Talbots, both subsidiaries were included in General Mills' Specialty Retailing Group ("SRG"). The SRG maintained a small office in New York, with approximately 15 employees – all on the General Mills payroll. The purpose of the SRG was to act as a coordinator for the various companies within the group. As with the officers and directors of General Mills, employees of the SRG were not involved in the day-to-day management of either Eddie Bauer or Talbots. If necessary, the SRG would assist the subsidiaries in preparing requests for funding from General Mills and in preparing various reports, both financial and operational, that would satisfy the General Mills requirements. The cost of the SRG was paid, on an allocated basis, by the member subsidiaries. Neither of the buyers of Eddie Bauer or Talbots offered to

purchase the SRG. Therefore, after the sale of the subsidiaries, the SRG was liquidated.

On the basis of the above facts, the Board concluded that neither Eddie Bauer nor Talbots were integrated with General Mills' food-packaging business. Both Eddie Bauer and Talbots were run by their own independent management. Each was responsible for purchasing its own materials and supplies. There was no shared use of offices, warehouses, or other facilities, no joint training programs for employees, and no joint use of trademarks or trade names.

Although General Mills provided its subsidiaries with some services, namely legal and tax, it was done primarily to assist General Mills in managing its investments. Also, even though both Eddie Bauer and Talbots belonged to the SRG, they received minimal benefits from this organization. Regardless, each was required to make payment to General Mills for membership in the group. Finally, while General Mills and its subsidiaries shared some officers and directors, these individuals had no involvement in the day-to-day operations of the subsidiaries.

Accordingly, the Board found that there was no functional integration, no centralized management and no economies of scale derived by the appellant and its subsidiaries. Instead, the Board found that the services and supervision provided by appellant were more akin to that involved in the oversight of an investment which any parent company would give to its investment in a subsidiary.

III. § 338(h)(10) Election

Initially, Jusco was courted as a prospective purchaser for both Eddie Bauer and Talbots. Several months into the process, however, Jusco determined it would not be able to purchase both subsidiaries and focused its attention on Talbots. On May 18, 1988, General Mills and Jusco entered into a stock-purchase agreement for the sale of Talbots. Jusco wished to have the transaction treated as a sale of assets whereas General Mills wished to have the transaction take the form of a stock sale.

General Mills timely filed its 1988 combined corporate excise return including its subsidiary Talbots. Included in Talbots' taxable income was the gain on the deemed sale of Talbots' assets attributable to the § 338(h)(10) election. In consideration for General Mills' consent to a § 338(h)(10) election under the Code, Jusco agreed to make a one-time payment of three million dollars to compensate General Mills for the additional tax costs.

For the reasons explained in the following Opinion, the Board found that the gain realized on the § 338 deemed sale of Talbots' assets was properly included in Talbots' Massachusetts taxable income subject to apportionment.

IV. Sale of Talbots' Intangibles

Pursuant to the stock-purchase agreement entered into between Jusco and General Mills, General Mills was required to assist with the sale and transfer of Talbots' assets to Jusco and/or its affiliates. The initial plan developed by Jusco, called for Talbots to sell its trademarks and intangibles to JUSCO BV, Jusco's subsidiary, for a price to

be determined. The funds received by Talbots for the trademarks and intangibles would then be distributed up to General Mills as a dividend. Lastly, the purchase price paid to General Mills by Jusco for the purchase of Talbots, would be reduced by the amount already paid to Talbots for the purchase of its trademarks.

By letter dated June 7, 1988, General Mills, through its representative Touche Ross, notified Jusco that the proposed plan would result in significant additional state taxes to General Mills. Touche Ross, General Mills' accounting firm, informed Jusco, and subsequently General Mills, that the way to circumvent the tax burden was to shift the transaction from Massachusetts to Delaware. Accordingly, a new plan was devised. Under the new plan, Talbots was to create a Delaware subsidiary, TalHC. Talbots would transfer all of its intangibles, including tradenames and trademarks, to TalHC which in turn would sell the intangibles to Jusco BV for $100 million. Finally, Jusco would purchase the Talbots stock from General Mills for $325 million. At some future date, TalHC would be liquidated. As stated in correspondence from Touche Ross to Jusco, "the effect of the series of transactions should improve General Mills' state tax liability since the gain by the Delaware subsidiary on the sale of intellectual property will attract no state tax."

To accommodate this plan, TalHC was incorporated in Delaware on June 16, 1998. Pursuant to the certificate of incorporation, the nature of the business was to "engage in any lawful act or activity for which corporations may be organized." TalHC had no employees or office. Its only assets were the Talbots intangibles and the sum of $10.00 in cash.

Shortly thereafter, on June 21, 1988, Talbots assigned all its rights in its trademarks and tradenames to TalHC. On the same day, Talbots and TalHC entered into a license agreement authorizing Talbots to continue to use the trademarks and tradenames. The license agreement did not, however, contain a provision for payment of royalties to TalHC. Furthermore, no royalties were ever paid to TalHC for Talbots' continued use of the trademarks and trade names.

On June 26, 1988, less than two weeks after TalHC was created, and only five days after the intangibles were transferred to it, TalHC sold the Talbots trademarks and tradenames to Jusco BV for $100 million. On the same day, Talbots and Jusco B.V. entered into a license agreement for the continued use of the tradenames and trademarks by Talbots. Unlike the agreement between TalHC and Talbots, this agreement provided for the payment of royalties based on a percentage of sales.[4] The next day, June 27, 1988, General Mills sold its shares of Talbots stock to Jusco for $325 million. Through this transaction, Jusco now owned Talbots and its wholly-owned subsidiary TalHC.

In its dealings with General Mills, Jusco agreed to indemnify General Mills for any additional federal tax liability as a result of the § 338(h)(10) election. General

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[4] The royalties paid to Jusco B.V. for the first year the agreement was in place, July 1, 1988 through June 31, 1989, totaled nearly $8.7 million, averaging out to approximately $23,800 per day. Therefore, TalHC's foregone revenue for the period June 21 through June 26, by not charging Talbots royalties for the five day use of the trademarks, amounted to more than $119,000.

Mills acknowledged that the revised plan for the sale of the Talbots intangibles would result in a reduction in its state tax liability and agreed that before any claim could be made to Jusco for indemnification with regard to the § 338 election, the state savings must first be netted against the increased federal tax liability.

Based on the evidence presented, the Board found that the contribution to TalHC and the leaseback by Talbots, of the Talbots intangibles, did not have any practical economic effect other than the creation of tax benefits. The Board found it compelling that the form of the transaction, as completed, was not devised until after General Mills determined that the original form would have negative state tax implications. Subsequently, Touche Ross, devised the second plan to "get around the tax burden."

The Board found it persuasive that there was no provision for the payment of royalties from Talbots to TalHC for the continued use of the trademarks and tradenames by Talbots. Lastly, the Board noted that neither TalHC nor Talbots had any involvement in the predetermined arrangements of the transactions. Accordingly, the Board found that the Commissioner properly disregarded the creation of TalHC and its dealings with Talbots' intangibles, determined the transaction to be a sale of Talbots' intangibles by Talbots, and included the gain in Talbots' net income.

V. Inclusion of Gain from Intangibles in Talbots' Sales Factor

The last issue in the present appeal is whether the Commissioner properly included in the numerator of

Talbots' "sales factor," the proceeds from the sale of the intangibled. The answer depends upon where the intangibles' "income-producing activity," based on costs of performance occurred.

Talbots was founded in 1946 by George Talbot. In 1947, George's son, Rudolph Talbot, and Rudolph's wife Nancy, bought out the franchise from Johnny Appleseed and changed the name to "The Talbots." The signature "Red Door" and the "Red T" logo were established in the 1950s. The company's association with high-quality manufacturers created brand awareness for Talbots customers while providing name recognition and appreciation.

When Talbots was acquired by General Mills in 1973, it had five retail stores and a small catalog operation with total annual sales of approximately $8 million. By the time the trademarks and tradenames and the business, were sold in 1988, Talbots had 119 stores in more than 20 different states and produced 25 catalogs each year which together had projected annual sales of $350 million.

From the time of its inception until it was sold in 1988, Talbots' headquarters were located in Massachusetts. Over the years, Talbots expanded its presence in Massachusetts and in 1988 built a state-of-the-art facility in Lakeville, Massachusetts, which housed its warehousing and distribution operations. All telephone sales operations were conducted at the Hingham headquarters.

In support of its position that the proceeds from the sale of the intangibles were not attributable to Massachusetts for purposes of determining Talbots' apportionment factor, General Mills offered the testimony of Robert Reilly, an appraiser and economist. Mr. Reilly suggested that the

sale activities surrounding the sale of the intangibles were an appropriate measure of income-producing activities. He further suggested that since General Mills' employees who were located in Minneapolis and Washington, D.C., not Massachusetts, performed the negotiations for and consummation of the sale of the intangibles, the proceeds from the sale of the intangibles could not be attributable to Massachusetts. The Board, however, found that Mr. Reilly's testimony focused primarily on the methods used in "valuing" intangibles, not an issue in the present appeal.

As an alternative, General Mills argued that the receipts from the sale of the intangibles should be sourced by where the activities that created value in the trademarks were performed, looking to the development costs of the trademarks. In support of this position, General Mills offered the testimony of Ms. Carol Stone, director of accounting for Talbots.

Ms. Stone noted that, throughout the years, Talbots relied heavily on its catalogs in promoting its name recognition and merchandise. Ms. Stone then explained the catalog production process in great detail. Initially, the catalog development department would meet to discuss what "message" was to be conveyed to the customer and how that was to be accomplished. As part of the process, Talbots' employees would meet with the merchants to decide which items were to have a larger presentation in the catalog.

From there, the development team would determine what location was to be used for the catalog pictures. Although the "shoot" locations were generally outside of the Commonwealth, Talbots' employees were responsible

for hiring all personnel involved in the process. After the pictures were taken, the film was sent back to the Hingham facility where the catalog development group would review it together with the merchants and prepare the catalog for print. Although Talbots used printers in several states, Ms. Stone testified based on her review of business records that a majority of the printing occurred in Virginia.

While she noted that many of the physical aspects of producing the catalog, including photography, printing and compilation, occurred outside of the Commonwealth, Ms. Stone conceded that at each step of the process, it was the Talbot's management and employees located in Massachusetts that were responsible for the decision making in preparing and finalizing the catalog.

Based on the foregoing, the Board found that regardless of where the catalog printers were located or where the legal work associated with the sale of the intangibles occurred, a greater portion of the intangibles' income-producing activity was performed in the Commonwealth than in any other state, based on cost of performance. *See* ***Surel v. Commissioner of Revenue***, 24 Mass. App. Tax Bd. Rep. 38 (1998). The Board found that the individuals responsible for making the decisions relative to the production of the catalogs and the overall management of Talbots were located in Massachusetts. All materials were submitted to Talbots' management for authorization. Accordingly, the Board found that the Commissioner properly included in the numerator of Talbots' "sales factor" the receipts from the sale of the intangibles.

Summary

Based on the evidence presented and to the extent it is a finding of fact, the Board found that the Commissioner's assessment of the full amount. of $10,865,588 in additional taxes was procedurally valid. Regarding the amount of the assessment, however, the Board found that neither Eddie Bauer nor Talbots were part of appellant's unitary business. They simply investments of General Mills. Therefore, the proceeds received by appellant from the sale of its stock interests were not properly includible in General Mills' Massachusetts gross income.

For the reasons explained in the following Opinion, however, the Board found that the gain recognized on the § 338 deemed sale of Talbots' assets was properly included in Talbots' Massachusetts net income and correspondingly General Mills' Massachusetts combined corporate excise return. The Board further found that for purposes of G.L. c. 63, § 38, determining Talbots' "sales factor" used to calculate Massachusetts taxable income, no portion of the gross proceeds or the gain recognized from the sale of the Talbots stock was includible in either the numerator or the denominator.

The Board further found that the creation of TalHC, the contribution to TalHC and the leaseback by Talbots, of the Talbots intangibles, did not have any practical economic effect other than the creation of tax benefits. Accordingly, the Board found that the Commissioner properly disregarded the form of the transaction and treated it as a sale of Talbots' intangibles by Talbots and, therefore, properly included the proceeds in the numerator of Talbots' "sales factor."

Lastly, despite the fact that the printing expenses attributable to the catalogs and the legal expenses for the sale of the intangibles were generated out of state, the Board found that a greater portion of the income-producing activities were performed in the Commonwealth than in any other state. Consequently, pursuant to G.L. c. 63, § 38(f), the Commissioner properly included in the numerator of Talbots' "sales factor," the gain recognized on the sale of the intangibles.

Accordingly, based on the parties' computations, pursuant to an Order under Rule 33 of the Rules of Practice and Procedure of the Appellate Tax Board, the Board issued a decision for General Mills in the amount of $634,077, based on the Board's finding that Eddie Bauer was not part of General Mills' unitary business and, therefore, the proceeds from the sale of stock were not properly includible in General Mills' Massachusetts taxable income.

OPINION

The five issues raised by General Mills' appeal are: (1) whether the Commissioner's assessment was procedurally correct; (2) whether General Mills' gain, recognized from the sale of its Eddie Bauer and Talbots' stock, is includible in General Mills' taxable income subject to apportionment as part of General Mills' unitary business; (3) whether the § 338(h)(10) election, which was treated as a sale of Talbots' assets, allowed the recognized gain to be included in Talbots' Massachusetts taxable income; (4) whether the gain recognized on the sale of Talbots' trademarks was properly includible in Talbots' taxable income; and, if so, (5) whether the gain recognized on the sale of the trademarks was includible in the numerator of

Talbots' "sales factor," for purposes of apportioning its income to Massachusetts.

I. Assessment

In its appeal to the Board, General Mills argued that the Commissioner failed to correctly assess $10,000,000 of the adjustments made after audit because two NOAs, dated March 6, 1992 and August 8, 1992, showed an assessment of only $865,588 in tax. In contrast, the January 7, 1992 NIA and the February 7, 1992 Instruction to Bill showed an assessment of $10,865,588 in tax. The Board found that the full tax at issue $10,865,588, was validly assessed prior to the issuance of the March 6, 1992 and August 8, 1992 NOAs.

G.L. c. 62C, § 26(b) authorizes the Commissioner to assess additional taxes within three years from the date the tax return was filed, or required to be filed, whichever occurs later. The Commissioner must first give notice of his intention to the person to be assessed, and "after the expiration of thirty days from the date of such notification, the commissioner shall assess the amount of tax remaining." G.L. c. 62C, § 26(b). After making an assessment, "the commissioner shall, as soon as may be, give written notice to the taxpayer of the amount of the assessment, [and] the amount of any balance due." G.L. c. 62C, § 31.

The act of assessment and the act of notifying taxpayers of the assessment are two separate and distinct acts. *See* ***EMC, Corporation v. Commissioner of Revenue***, 433 Mass. 568, 569 (2001). "The assessment is the act by which the Commissioner determines or verifies and records the amount of tax due." ***Menard v. Commissioner of***

Revenue, 12 Mass. App. Tax Bd. Rep. 174, 179 (1990). Absent evidence proving otherwise, the date on the notice of assessment is the actual assessment date. *See* ***Ricciardi v. Commissioner of Revenue***, 9 Mass. App. Tax Bd. Rep. (1987); ***Wolf v. Commissioner of Revenue***, 2 Mass. App. Tax Bd. Rep. 164 (1983). Such is not the case, however, where there is reliable evidence indicating an earlier assessment date. ***Tambrands, Inc. v. Commissioner of Revenue***, 19 Mass. App. Tax Bd. Rep. 135 (1996), *aff'd* 46 Mass. App. Ct. 522 (1999); ***Jewel Companies v. Commissioner of Revenue***, 12 Mass. App. Tax Bd. Rep. 101, 110 (1990).

The Commissioner's regulations provide that an "assessment" is the "determination or verification of the amount of the tax" and that an "instruction to bill" is a "signed and dated statement that a deficiency assessment has been made." 830 CMR 62C.26.1(2). The regulations further provide that a deficiency assessment occurs "on the date the Commissioner enters the amount of the assessment upon the instruction to bill." 830 CMR 62C.26.1(6)(f).

On January 7, 1992, the Commissioner issued a NIA notifying General Mills' of his intent to assess additional taxes for fiscal year 1989 in the amount of $10,865,588, plus interest. More than thirty days later, on February 7, 1992, the Commissioner generated an Instruction to Bill showing that the Commissioner had in fact assessed, for fiscal year 1989, additional taxes in the amount of $10,865,588, plus interest. The Instruction to Bill showed a zero balance due, reflecting the fact that General Mills had already made full payment of the amount shown on the NIA. Subsequently, on March 6, 1992, and August 8, 1992, the Commissioner issued NOAs showing an erroneous

amount of tax assessment in the amount of $865,588, due to a "truncation" error which only printed the assessment amount through the first six figures, in contrast to the $10,865,588 assessed on February 7, 1992. Similarly, in reflecting General Mills' payment, the NOA eliminated figures in the tens of millions column.

On September 24, 1994, after the Commissioner's denial of General Mills' abatement application, General Mills timely filed its appeal with the Board. In its appeal, for the first time, General Mills claimed that the Commissioner incorrectly assessed additional taxes in the amount of $10,000,000, the discrepancy between the 1992 NIA and Instruction to Bill, and the subsequent NOAs. Attached to its Answers filed with the Board, the Commissioner issued a revised NOA for the full assessment of $10,865,588.

Based on the evidence, the Board found that the Commissioner made assessment in the full amount of $10,865,588, on February 7, 1992, more than thirty days after issuing the NIA. By letter dated February 5, 1992, General Mills submitted payment in the amount of $15,809,545, for "the additional tax and interest assessed due to a Massachusetts field audit." Consequently, the Board found that General Mills was notified of the Commissioner's full assessment of $10,865,588. Moreover, the Board found that General Mills was in no way prejudiced by the truncated subsequent notice of assessment. *See* ***Tambrands,*** 46 Mass. App. Ct. at 527 (under a "fluid" time limitation such as whether a notice of assessment was given "as soon as may be," attendant circumstances such as prejudice to a taxpayer "need to be considered.") General Mills had already paid the full amount of the February 7, 1992 assessment and, on its September 24, 1992, application for abatement, requested a refund of the

full amount of $10,865,588. Accordingly, General Mills was fully aware of the amount of the deficiency assessment. For all of the foregoing reasons, the Board ruled that the assessment was procedurally valid.

II. Taxation of Gain Recognized from the Sale of the Eddie Bauer and Talbots stock

Every domestic and foreign corporation engaged in business in the Commonwealth is required to pay an excise based in part on its net income derived from business activities carried on in Massachusetts. G.L. c. 63, § 39. Computation of a corporation's Massachusetts net income generally starts with its federal gross income as defined under the Code, as in effect for the taxable year, with some exceptions not relevant to this appeal. G.L. c. 63, § 30.

The entire amount of a corporation's net income is subject to the Massachusetts corporate excise if the corporation has no income from business activity which is taxable in another state. G.L. c. § 38(b). If, however, the corporation has income from business activity taxable both in Massachusetts and elsewhere, as in the present appeal, its taxable net income is apportioned to Massachusetts by means of a three-factor formula based on the ratio of its Massachusetts property, payroll and sales to its property, payroll and sales everywhere. G.L. c. 63, § 38(c)-(f).

It is uncontested that General Mills and its subsidiaries Eddie Bauer and Talbots were engaged in business in the Commonwealth and generated income. In fact, Talbots was a domestic corporation with its headquarters located in Hingham, Massachusetts. The income from the entities' in-state activities was properly reported on the 1988 combined corporate excise return, and the tax shown due

thereon was paid. The Commissioner maintains, however, that General Mills should have included in its net income the gain realized on the sale of its interests in Eddie Bauer and Talbots. For the following reasons, the Board disagrees.

"It has long been settled that 'the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.'" ***Exxon Corp. v. Wisconsin Department of Revenue***, 447 U.S. 207, 219 (1980) *quoting* ***Northwestern States Portland Cement Co. v. Minnesota***, 385 U.S. 450, 460 (1959). However, both the Commerce Clause and the Due Process Clause, of the United States Constitution, require that there be some minimal connection or "nexus" between the corporation's interstate activities and the taxing state. ***Exxon***, 447 U.S. at 220. States may not tax income arising out of interstate activities unless there is a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." ***Container Corporation of America v. Franchise Tax Board***, 463 U.S. 159, 165-166 (1983).

The requisite connection for taxation is believed to exist when the foreign corporation is a member of a unitary business enterprise and the income is derived from the unitary business. *See generally* ***Allied-Signal, Inc. v. Division of Taxation***, 504 U.S. 768 (1992). The unitary business principle is the "linchpin of apportionability" for state income taxation of an interstate enterprise. *See* ***Mobil Oil Corp. v. Comm'r of Taxes of Vt.***, 445 U.S. 425, 439 (1980).

> If a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's *total income*. . . . In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of activities unrelated to the [taxpayer's activities] in that State.' (Emphasis added.)

Exxon, 447 U.S. at 223 *quoting* ***Mobil Oil Corp.*** 445 U.S. 425, 439.

In the present appeal, the Commissioner argued that both Eddie Bauer and Talbots were part of General Mills' unitary business and, therefore, the recognized gain from the sale of the stock was includible in General Mills' taxable income. However, General Mills maintained, and the Board found, that neither Eddie Bauer nor Talbots were part of General Mills' unitary business.

In ***Container Corp. of America v. Franchise Tax Board***, 463 U.S. 159 (1983), the Supreme Court noted that "the unitary business concept is [ ] not, so to speak, unitary: there are variations on the theme, and any number of them are consistent with the underlying principles motivating the approach." ***Id.*** at 168. Generally, the indicia of a unitary business are functional integration, centralization of management and economies of scale. ***Id.*** at 179.

The Supreme Court has held that a state may "properly treat [a taxpayer's] business as a unitary one" in the presence of "unity of *ownership and management*" and centralized purchasing. ***Butler Brothers v. McColgan***, 315 U.S. 501, 508 (1942) (emphasis added). Accordingly, in determining whether a subsidiary is engaged in a unitary

business with its parent, among the considerations deemed "noteworthy," is the "managerial role played by the [parent] in its subsidiaries' affairs." ***Jacob Licht v. Commissioner of Revenue***, 1999 ATB Adv. Sh. 12, 24 *quoting* ***Container Corp. of America***, 463 U.S. at 180, n.19.

In the present appeal, the Commissioner argued that through the overlap of officers and directors and the services of the Specialty Retail Group, there was a centralized management for General Mills and its subsidiaries which supported a conclusion that the subsidiaries were part of General Mills' unitary business. The Board, however, found that the relationship between General Mills and its subsidiaries did not satisfy the requirements for a unitary business and was more closely analogous to the ones in ***ASARCO, Inc. v. Idaho State Comm.***, 458 U.S. 307 (1982) and ***Woolworth Co. v. Taxation & Revenue Department***, 458 U.S. 354 (1982).

In ***ASARCO***, the Supreme Court found that the taxpayer and its subsidiaries were not part of a unitary business. In that case, Idaho sought to tax dividend income and capital gains, received by the parent from five of its subsidiaries that did no business in that state.

Based on the evidence, the Court determined that ASARCO's subsidiaries operated independently. In its decision, the Court emphasized that the actual exercise of control versus the legal right to control is the appropriate test for determining whether or not a unitary business exists. Applying this standard, the Court found the controlled subsidiaries to be "merely an investment" of the parent. ***Id.*** at 323.

Similarly, in ***Woolworth***, the Supreme Court found a non-unitary business despite the fact that there existed "some managerial links." ***Id.***, at 368. In that case, New Mexico sought to tax dividends received by Woolworth from four foreign subsidiaries, three wholly-owned and a fourth in which Woolworth owned a majority interest, none of whom did any business in the state. Through its stock ownership, Woolworth had the ability to elect all of the subsidiaries' directors. The Court ruled, however, that "the *potential* to operate a company as part of the unitary business is not dispositive when, looking at 'the underlying economic realties of the unitary business,' the dividend income from the subsidiaries in fact is [derived] from unrelated business activity which constitutes 'a discrete business enterprise.'" ***Id.*** at 363.

The Court held that the proper inquiry looks to 'the underlying unity or diversity of business enterprise,' not to whether the non-domiciliary parent derives "some economic benefit – as it virtually always will – from its ownership of stock in another corporation." ***Id.*** at 363-64. The Court found that decisions about merchandise, inventory, store site selection, advertising and accounting control were made by the subsidiaries "autonomously and independently." ***Id.*** at 364-365.

In its decision, the Court found that although there existed some managerial links, as evidenced by "irregular in-person and 'frequent' mail, telephone and teletype communication between the upper echelons of management of the parent and the subsidiaries," the fact that "major financial decisions such as the . . . creation of substantial debt had to be approved by the parent," and the fact that Woolworth's "published financial statement

such as its annual report, were prepared on a consolidated basis," they were not controlling. ***Id.*** at 368-369.

The Court further noted, that Woolworth "did not provide 'many essential corporate services' for the subsidiaries." ***Id.*** at 369. The Court determined that Woolworth's operations were not "interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization of capacity.'" ***Id.*** Consequently, the Court concluded that Woolworth's activities were more in the line of "occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary" and not part of a unitary business. ***Id.***

Applying the Supreme Court's analysis in ***Woolworth*** and ***ASARCO***, the Board in ***W.R. Grace & Co. v. Commissioner of Revenue***, 1999 ATB Adv. Sh. 622 (November 19, 1999) found that unity of ownership did not necessarily result in the "coordination or integration of the disputed businesses." ***Grace***, 1999 ATB Adv. Sh. at 634. The Board found, as in the present appeal, that the subsidiaries were run by their respective management teams. Each did its own advertising; its own purchasing; located and operated their own store sites; and received and distributed their own merchandise. There was no joint personnel training program; no joint use of trademarks; and no shared use of office space or other facilities. ***Id.*** at 645.

Based on these facts, the Board found that there was "no functional integration, no centralized management and no economies of scale" derived by Grace and its subsidiaries. ***Id.*** at 634-635. As in the present appeal, although the parent in ***W.R. Grace*** provided certain financial, administrative, legal and staff functions and

services to the subsidiaries, at no cost, the Board found these services to be "more in the nature of a stewardship [] function overseeing investments and one which any parent would give to an investment in a subsidiary." ***Id.*** at 635.

In the present appeal, the Board found that Eddie Bauer and Talbots were run by their own independent management teams. Each was responsible for purchasing its owns materials and supplies. There was no shared use of offices, warehouses, or other facilities, no joint training programs for employees, and no joint use of trademarks or tradenames.

Although both Eddie Bauer and Talbots belonged to General Mills' Specialty Retailing Group, they received minimal benefits from this organization. In addition, each was required to make payment to General Mills for membership in this group. Also, although General Mills and its subsidiaries shared officers and/or directors, the Board found that these individuals had no involvement in the day-to-day operations of the subsidiaries.

The taxpayer is required to demonstrate by clear and cogent evidence that there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise. ***Container Corp.***, 463 U.S. at 180. In the present appeal, the Board found that there was no significant functional integration, centralized management or economies of scale realized by the appellant and its subsidiaries. Instead, as in ***Woolworth***, ***ASARCO*** and ***Grace***, the Board found in the present appeal that the services and supervision provided by General Mills were more akin to those involved in a parent company's oversight of its investment in a subsidiary. The

Board concluded that Eddie Bauer and Talbots were not part of General Mills' unitary business and that they had no rational relationship to General Mills' Massachusetts business. Therefore, the Board ruled that taxing General Mills' gain realized from the sale of stock in these entities would result in the taxation of extraterritorial values.

III. § 338(h)(10) Election

On its 1988 Massachusetts combined return, General Mills included in Talbots' income column the gain recognized on the § 338 deemed sale of Talbots' assets. General Mills now argues, however, that this gain cannot properly be taxed by Massachusetts since Talbots was not part of its unitary business. For the following reasons, the Board found that the gain was properly included in Talbots' Massachusetts net income subject to apportionment.

If two or more domestic or foreign corporations participate in the filing of a federal consolidated return, they may elect to compute their Massachusetts corporate excise based on their combined "net income." G.L. c. 63, § 32B. The corporations' combined net income is ascertained by first separately determining the taxable net income of each corporation apportioned to this Commonwealth and then adding together each corporation's separately determined net income. G.L. c. 63, § 32B.

"Net income" is arrived at by taking certain deductions from "gross income," which is "gross income as defined under the provisions of the Federal Internal Revenue Code, as amended and in effect for the taxable year." G.L. c. 63, § 30. In the present appeal, for federal tax purposes, General Mills and Jusco elected the treatment available under § 338 of the Code.

Section 338 provides, in pertinent part:

> If a purchasing corporation makes an election under this section . . . then, in the case of any *qualified stock purchase*, the target corporation
>
> (1) *Shall be treated* as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and
>
> (2) Shall be treated as a new corporation which purchased all of the assets . . . at the beginning of the day after the acquisition date. (Emphasis added.)

Code § 338(a).

The result of the election is twofold. First, the target corporation, in this case Talbots, recognizes a gain based on the difference between the basis of its assets and the assets' fair market value. Code §§ 1001 and 1245. This gain is then included in the target corporation's federal gross income. Also, the target corporation gets a stepped-up basis in the assets. Code § 338(b). Second, if the target corporation and the corporation selling the stock are part of a consolidated group and the target corporation has recognized the gain, then the selling corporation does not recognize gain on the sale of stock in the target corporation when the stock is sold. Code § 338 (h)(10)(A).

In the present appeal, General Mills sold its Talbots stock to Jusco and Jusco made a § 338 election. As a result, Talbots was treated as if it had sold its assets for fair market value. The recognized gain was then included in Talbots' federal gross income and, correspondingly, its Massachusetts net income. G.L. c. 63, § 30.

Accordingly, the Board found that Talbots properly included in its income column of combined return the gain recognized on the deemed sale of its assets, *See* ***Combustion Engineering, Inc. v. Commissioner of Revenue,*** 2000 ATB Adv. Sh. 207, 212 (March 29, 2000.)

After determining a corporation's net income, the next step is to determine the Massachusetts tax due pursuant to G.L. c. 63, § 38. Where a corporation, such as Talbots, derives income from business activity taxable both in Massachusetts and elsewhere, its taxable net income is apportioned to Massachusetts by means of a three-factor formula based on the ratio of its Massachusetts property, payroll and sales to its property, payroll and sales everywhere. G.L. c. 63, § 38(c)-(f).

For purposes of determining a corporation's sales factor, the statute defines the term "sales" as the "gross receipts of the corporation ***except . . . gross receipts from the . . . disposition of securities***." (*emphasis added).* G.L. c. 63, 38(f). In ***Combustion Engineering***, *infra,* the Board ruled that gain recognized in a 338(h)(10) election, albeit treated federally as a sale of assets by the target corporation, is **not** a "sale" for purposes of the apportionment formula because it is in fact a sale of stock. ***Combustion Engineering***, 2000 ATB adv. Sh. at 214. In its decision, the Board ruled,

> the federal treatment of the sale – based on a fictitious recasting of the actual transaction for purposes of federal tax law – does not determine whether the proceeds of the transaction should be treated as 'sales' for purposes of the Massachusetts apportionment formula. Whatever the transaction may be 'deemed' to be for federal purposes, it is, in actuality, a sale of stock, the

> proceeds from which are specifically excluded from the sales factor.

Combustion Engineering, 2000 ATB Adv. Sh. at 216.

Accordingly, the Board ruled in the present appeal that no portion of the recognized gain was includible in either the numerator or denominator in calculating Talbots' "sales factor."

VI. The Sale of Talbots' Intangibles

The Commissioner also included in the subject assessment additional taxes resulting from the gain recognized on the sale of Talbots' intangibles. The Commissioner determined that, although the sale was structured so that TalHC was the seller of the intangibles, in substance it was a sale by Talbots. Consequently, the Commissioner determined that the gain recognized by Talbots was properly includible in Talbots' Massachusetts net income.

The United States Supreme Court has recognized that tax reduction is a legitimate goal of business. ***Commissioner of Internal Revenue v. Court Holding Co.***, 324 U.S. 331, 334 (1945). A taxpayer is entitled to arrange a business transaction so as to minimize the tax due so long as the transaction has a valid business purpose. ***Gregory v. Helvering***, 293 U.S. 465 (1935).

In evaluating transactions, the Courts invoke a variety of doctrines such as:

> lack of business purpose, substance over form, sham-arrangement, economic reality and step transaction to disregard the form of a transaction

> where the facts show that the form of the transaction is artificial and is entered into for the *sole* purpose of tax avoidance and there is *no independent purpose* for the transaction.

(Emphasis added.) ***Sherwin-Williams Co v. Commissioner of Revenue***, 2000 ATB Adv. Sh. 468, 495 (July 19, 2000) quoting ***Falcone v. Commissioner of Revenue***, 20 Mass. App. Tax Bd. Rep. 61, 64-65 (1996); *See also* ***Syms Corp. v. Commissioner of Revenue***, 2000 ATB Adv. Sh. 711, 751 (September 14, 2000).

Where the evidence shows that the transaction lacks economic substance, the transaction must be disallowed. ***Sherwin-Williams,*** 2000 ATB Adv. Sh. at 496. Whether a transaction lacks economic substance depends upon whether there exists a valid business purpose beyond the creation of tax benefits. *See* ***Gregory v. Helvering***, 293 U.S. 465 (1935); ***Court Holding***, 324 U.S. 331. "Substance and not form is to be regarded in the application of the tax laws." ***Anderson v. Commissioner of Corporations & Taxation***, 312 Mass. 40, 44 (1942).

Recently, in ***Sherwin-Williams*** and ***Syms***, the Board upheld the Commissioner's denial of a deduction for royalty payments by a parent corporation to its wholly-owned subsidiary based on the "sham transaction" and "substance-over-form" analyses. In each case the taxpayer created one or more wholly-owned subsidiaries to which it transferred its trademarks. The subsidiary leased the trademarks back to the taxpayer parent corporation which, pursuant to a licensing agreement, made royalty payments to the subsidiary. *See generally,* ***Sherwin-Williams***, 2000 ATB Adv. Sh. 468; ***Syms,*** 2000 ATB Adv. Sh. 711. The Board found that the taxpayers failed to prove that the transfer and license-back transactions

served any business purpose beyond mere tax advantages. ***Sherwin-Williams***, 2000 ATB Adv. Sh. at 497; ***Syms***, 2000 ATB Adv. Sh. at 753.

The Board found that the non-tax business purposes put forth by Sherwin-Williams either (1) could not be achieved, (2) had already been achieved, or (3) would expose Sherwin-Williams to serious economic risk. ***Id.*** at 498. Instead, the Board found that the subject transactions were "no more than 'a pure paper shuffle, having no potential consequences for the business in which the corporations engaged.'" ***Sherwin-Williams***, 2000 ATB Adv. Sh. at 498, *quoting* ***Yosha v. Commissioner of Internal Revenue***, 861 F.2d 494, 497 (7th Cir. 1988). The Board concluded that the transfer and license-back transactions "lacked business purpose and economic substance beyond the creation of tax deductions." ***Sherwin-Williams***, 2000 ATB Adv. Sh. at 496; ***Syms***, 2000 ATB at 751.

The Court has ruled that a series of interrelated transactions may, for tax purposes, be treated as a single integrated event if each step lacks independent economic significance. ***Commissioner of Revenue v. Dupee***, 423 Mass. 614, 624 (1996). Using the "step-transaction" theory in ***Falcone***, the Board ruled that the Commissioner properly included in the taxpayer's income proceeds received from the sale of Massachusetts property. 20 Mass. App Tax Bd. Rep. at 63.

In ***Falcone***, the taxpayer, a non-resident, formed a corporation to which he transferred several properties located in Massachusetts, in exchange for all the stock of the corporation. ***Falcone***, 20 Mass. App. Tax Bd. Rep. at 62. Less than two months later, the taxpayer sold the

stock of the corporation to the Falcone Family Trust and on the same day liquidated the corporation. ***Id.*** There was no evidence that the corporation ever conducted any other business. ***Id.***

The taxpayer argued that the gain resulted from the sale of stock, not from the sale of real property, and therefore was not subject to the Massachusetts personal income tax. The Board disagreed. Notwithstanding that tax reduction is a legitimate goal of business, "[s]ubstance and not form is to be regarded in the application of the tax laws." **Falcone**, 20 Mass. App. Tax Bd. Rep. at 63 *quoting* ***Anderson v. Commissioner of Corporations & Taxation***, 312 Mass. at 44.

The Board in ***Falcone*** noted that if a series of steps do not have independent economic significance, they must be treated as a single step for tax purposes. ***Id.*** at 63. The Board found that none of the intermediary steps by which the taxpayer transferred the property had economic significance. The Board concluded that the taxpayer attempted to use the new corporation for the "sole purpose of reducing his taxes. Its creation and existence served only the function of transferring title to the [p]roperties from [the taxpayer] to the Family Trust in order to escape taxation." ***Id.*** at 65. The Board found that the taxpayer's goal was to sell the properties at a gain and he did so through a circuitous path, all in a period encompassing roughly two months. ***Id.***

Similarly, in the present appeal, General Mills' goal was to sell the Talbots' intangibles without incurring additional taxes. To accomplish this task, TalHC was formed and acted as the intermediary. TalHC was formed, the intangibles were transferred to it and the sale of the

intangibles all occurred within a few weeks period of time. Consequently, the Board found that, based on the step-transaction doctrine, for tax purposes the transaction should be treated as a sale of Talbots' intangibles by Talbots.

In the present appeal, the Board found that the creation of TalHC, the transfer of Talbots' intangibles and the subsequent sale by TalHC, lacked economic substance. In support of its contention that the form of the transaction be given full credence, General Mills argued that the transaction was in furtherance of its overall business purpose to sell the Talbots stock. General Mills also maintained that it was Jusco, not General Mills, who developed the final plan and that it had nothing to do with the formation of the plan and that, pursuant to the purchase and sale agreement, General Mills was required to accommodate Jusco and carry out the transaction.

The Board found that TalHC had no office, no employees and no assets other than the Talbots intangibles and $10.00 in a bank account. There was no evidence presented of any other business activities carried on by TalHC. Although a licensing agreement was entered into, Talbots did not make royalty payments to TalHC for the continued use of the intangibles. Lastly, the evidence presented showed that from the beginning it, was intended that TalHC be liquidated after completion of the sale transaction.

Consequently, regardless of the theory of analysis, the determinative question is whether the transaction had economic significance beyond the mere creation of tax benefits. In the present appeal, the Board found that the sole purpose of creating TalHC was to relocate the Talbots

intangibles to a Delaware subsidiary, have the sale completed, and thereby escape Massachusetts state tax on the gain. As in ***Sherwin-Williams*** and ***Syms***, the Board in the present appeal found the transfer to be no more than a "'paper shuffle.'" ***Sherwin-Williams***, 2000 ATB Adv. Sh. at 498 [citation omitted]; ***Syms***, 2000 ATB Adv. Sh. at 753 [citation omitted].

The transaction as completed lacked economic substance beyond the mere creation of tax benefits. Notwithstanding the form of the transaction, its substance was the direct sale of the intangibles by Talbots.

V. Inclusion of Proceeds From the Sale of Intangibles in Talbots' "sales factor"

Having determined that the sale of the Talbots intangibles was in fact a sale by Talbots, and includible in Talbots' Massachusetts net income, the Commissioner also assessed additional taxes based on the re-computing of Talbots' "sales factor" for purposes of apportioning its net income to Massachusetts. Specifically, the Commissioner included in the numerator of Talbots' "sales factor" the proceeds received from the sale of the trademarks, tradenames and other intangibles.

In determining a corporation's sales factor, sales of intangible property are deemed to be Massachusetts sales if:

1. the income-producing activity is performed in this commonwealth; or

2. the income-producing activity is performed both in and outside this commonwealth and a greater proportion of this income-producing

> activity is performed in this commonwealth than in any other state, **based on costs of performance**.

G.L. c. 63, § 38(f) (emphasis added). ***Surel***, 24 Mass. App. Tax Bd. Rep. At 42.

General Mills suggested that the income-producing activity of Talbots' intangibles be allocated based on one of two methods. First, General Mills argued that the income-producing activity be attributed solely to the state where the sale and the activities leading up to the sale occurred – Minnesota or New York.

In the alternative, General Mills suggested that the income-producing activity be allocated based on the intangibles' "development costs," which are their creation and commercialization costs. General Mills focused on (1) where the trademarks were registered, and (2) where the advertising costs were incurred. Noting that Talbots relied primarily on its catalog for advertising, General Mills relied on where the costs of producing the catalogs occurred.

Similarly, the Board looked to the intangibles' development costs. Aware that the catalogs were an important factor in generating value for Talbots' intangibles, the Board, nevertheless, found that in determining where the intangibles' income-producing activity occurred, the proper analysis was not to focus solely on the catalogs' printing costs. Instead, the Board found that the proper analysis was to look to the overall business activities of Talbots in promoting its name recognition, awareness and customer satisfaction, all of which imparted value to the intangibles.

The Board recently addressed the issue of an "income-producing activity" in its decision ***Interface Group-Nevada v. Commissioner of Revenue***, 2000 ATB Adv. Sh. 324 (May 25, 2000). The taxpayer, Interface Group, was comprised of three divisions, one of which was the Travel Unit. The Travel Unit organized and operated group travel tours in the form of package vacation tours, which included hotel accommodations, air fare and ground transfers. ***Id.*** at 325.

The taxpayer sought to exclude from "the numerator of its "sales factor" revenues generated by its Travel Unit on the ground that the income-producing activity was generated more in other states than in Massachusetts. The Board found that it was the Product Development Department, located in Needham, Massachusetts, that developed the vacation packages and which did the contracting with the hotels and airlines. ***Id.*** at 330-1. The Board also found that the Massachusetts employees were responsible for developing and distributing brochures to the independent travel agents. ***Id.*** at 331.

The final products, the travel packages, were sold by independent travel agents not by the taxpayers' employees. ***Id.*** It was this last point upon which the taxpayer argued in ***Interface*** that the receipts were not "Massachusetts sales." The Board, however, found that the taxpayer "carried on significant income-producing activity in the Commonwealth." ***Id.*** at 333. Although the Travel Unit's employees did not directly sell the travel packages, "many of the activities necessary to package a vacation tour were performed in [the Commonwealth]." ***Id.*** at 357. The Board found that the taxpayer's activities in Massachusetts were "necessary steps in creating the ultimate vacation tour product" and, therefore, were the relevant

income-producing activities. ***Id.*** at 359. It is the costs associated with these activities that were determinative. ***Id.*** at 360.

In the present appeal, although the Massachusetts employees did not physically produce the catalogs, they were the individuals responsible for their creation, development and distribution. These employees were also responsible for contracting with the printers and all others involved in the catalog. Furthermore, the Board found that production of the catalogs was not the sole item that generated value for the intangibles. Instead, the Board found that it was the business operations and management which increased the intangibles' value. Talbots' headquarters, and consequently, the individuals with all aspects of decision-making authority, were always located in Massachusetts. All billing and customer relations were performed by Massachusetts employees. Orders for goods were sent to and filled from Talbots' distribution centers located in Massachusetts.

Accordingly, the Board found that many of the necessary activities in creating the Talbots' catalogs and expanding Talbots' name recognition were performed in the Commonwealth. Therefore, the Board found and ruled that the income-producing activities which gave rise to the intangibles' value through name recognition and customer appreciation were conducted more in the Commonwealth than in any other state. Therefore, the Board found that the proceeds generated from the sale of the intangibles were properly includible in the numerator of Talbots' sales factor. *See generally* ***Clipper Express Company v. Commissioner of Revenue***, 7 Mass. App. Tax Bd. Rep. 175 (1986) (although taxpayer performed physical activities, associated with its freight transportation business, in

the Commonwealth, the location of taxpayer's administrative headquarters was more controlling.)

Conclusion

In conclusion, the Board found and ruled that neither Eddie Bauer nor Talbots were part of General Mills' unitary business. Therefore, the proceeds generated from appellant's sale of its Eddie Bauer stock were not subject to the Massachusetts corporate excise. With respect to the sale of the Talbots stock, however, appellant's § 338 election, which treated the transaction as a "deemed sale" of assets by Talbots, resulted in recognized gain for Talbots that was properly includible in Talbots' Massachusetts gross income, and consequently, Talbots' net income.

The Board further found that the sale of the Talbots' intangibles lacked economic significance and served no valid business purpose. Therefore, the Board found that the sale transaction was properly reclassified as a sale by Talbots, the proceeds of which were includible in Talbots' Massachusetts net income. Lastly, the Board found that the intangibles' "income-producing activity" occurred more in the Commonwealth than in any other state and, therefore, the income generated from their sale was correctly included in the numerator of Talbots' "sales factor."

Accordingly, the Board issued a decision for General Mills and granted an abatement with respect to the tax on the sale of the Eddie Bauer stock, pursuant to a Rule 33 Order, in the amount of $634,077.

APPELLATE TAX BOARD

By: /s/ Abigail A. Burns
Abigail A. Burns,
Chairman

A true copy,

Attest: /s/ Alan L. Gold
Ass't Clerk of the Board

APPENDIX E

[LOGO]

THE COMMONWEALTH OF MASSACHUSETTS
Appellate Tax Board
Leverett Saltonstall Building, Government Center
100 Cambridge Street
Boston, Massachusetts 02202

Docket No. F223398

GENERAL MILLS, INC. & SUBSIDIARIES,

Appellant.

COMMISSIONER OF REVENUE,

Appellee.

DECISION

The decision is for the appellant on the issue of the unitary business status of Eddie Bauer, Inc. and for the appellee on all other issues. An abatement is granted in the amount of $634,077 of tax plus statutory additions.

APPELLATE TAX BOARD

By /s/ Kenneth W. Gurge Chairman.
/s/ Frank Scharaffa Member.
/s/ [Illegible] Member.
/s/ Abigail A. Burns Member.
/s/ Donald E. Gorton III Member.
Attest: /s/ Alan L. Gold Ass't Clerk.

Date: Sep 15, 1998
(Seal)

NOTICE: An appeal may be taken to the Massachusetts Appeals Court by either party to these proceedings. An appeal under the Informal Procedure is limited by c. 58A, s. 7A to requests of law raised by the pleadings or by an agreed statement of facts or shown by a report of the Board. A claim of appeal should be filed with this Board in accordance with the Massachusetts Rules of Appellate Procedure.

[LOGO]
(617) 727-3100
(617) 727-6234 FAX

The Commonwealth of
Massachusetts Appellate Tax Board
Leverett Saltonstall Building,
Government Center
100 Cambridge Street, Boston 02202

Docket No. F223398

GENERAL MILLS, INC. & SUBSIDIARIES,
Appellant.

COMMISSIONER OF REVENUE,
Appellee.

ORDER VACATING DECISION AND ORDER UNDER RULE 33

On the Board's own motion and pursuant to Rule 33 of the Rules of Practice and Procedure of the Appellate Tax Board (831 CMR 1.33), the Board finds and rules as follows:

1. This decision issued in this appeal on September 15, 1998 is hereby vacated.

2. The Board finds and rules that the decision is for the appellant on the issue of the unitary business status of Eddie Bauer, Inc.

3. The Board finds and rules that the gain realized on the sale of The Talbots, Inc. stock by General Mills, Inc. was properly includable as income to The Talbots, Inc. pursuant to G.L. c. 63, § 30 as a result of the IRC Section 338(h)(10) election.

4. The Board finds and rules that no portion of the realized gain or of the gross proceeds of the sale of The Talbots, Inc. stock is includable in either the numerator or the denominator of its "sales factor" under G.L. c. 63, § 38. For purposes of the Massachusetts apportionment statute, in contrast to the definition of income under G.L. c. 63, § 30, the transaction is treated as a sale of stock rather than a deemed asset sale.

5. The Board further finds and rules that the decision is for the appellee on all other issues.

6. Accordingly, the Board hereby orders the parties to compute the amount of tax, exclusive of interest and penalties to be abated as a result of the foregoing findings and rulings. Pursuant to Rule 33 of the Rules of Practice and Procedure of the Appellate Tax Board, the parties shall, if they are in agreement as to the amount of tax to be abated, jointly file with the Clerk a computation showing the amount of tax to be abated. If the parties do not agree as to the amount of tax to be abated, each of the parties shall file with the Clerk a computation of said amount. The parties are directed to comply with this Order within thirty (30) days of the date of this Order. The Board will not extend the

thirty-day period absent a showing of extraordinary circumstances justifying an extension.

ORDERED ACCORDINGLY.

APPELLATE TAX BOARD

By /s/ Kenneth W. Gurge Chairman.
/s/ Frank Scharaffa Member.
/s/ Abigail A. Burns Member.
/s/ Donald E. Gorton III Member.
/s/ [Illegible] Member.
Attest: /s/ [Illegible] Asst. Clerk.

Date: Aug. 19, 1999
(Seal)

Note: This Order does not constitute a final decision. Such a final decision will be rendered following receipt of the parties' computations. The Board will honor the parties' previously filed requests for issuance of a findings of fact and report following its issuance of a final decision. This time in which to file a notice of appeal will not begin to run until the issuance of the findings of fact and report.

APPENDIX F

[LOGO]
MITCHELL ADAMS
COMMISSIONER
SANDRA L. STEELE
DEPUTY COMMISSIONER

The Commonwealth of
Massachusetts Department of Revenue
Leverett Saltonstall Building,
100 Cambridge Street, Boston 02202

General Mills, Inc. &	DATE	August 18, 1994
Subsidiaries	ID #	410 274 440
c/o Tax Department	PERIOD	05/89
P. O. Box 1113	TAX TYPE	Corporate
Minneapolis, Minnesota 55440	CLAIM #	2265 79 5020 00

NOTICE OF PARTIAL ABATEMENT

Dear Taxpayer(s):

The Massachusetts Department of Revenue (DOR) has concluded action on your Application for Abatement. Your application has been denied in part. Any amount not abated is hereby denied.

General Mills, Inc. will be allowed to include tangible property from construction work-in-progress in the denominator of the property factor. Unitary income was properly included in the Massachusetts income subject to apportionment. The negative tax addback was properly reversed.

This determination by DOR is final. Any further appeal is with the Appellate Tax Board, 100 Cambridge Street, Room 1010, Boston, MA 02202. If you choose to file an appeal, it must be received by the Appellate Tax Board within sixty (60) days of the date of this notice, together with a minimum filing fee of $65.00 for appeals up to $65,000.00 and an additional $.10 for every $100.00 over $65,000.00, made payable to the Appellate Tax Board. A copy of the appeal must be filed with the Commissioner of Revenue, Room 806, 100 Cambridge Street, Boston,

MA 02204, pursuant to Rule 4 of the Rules of the Appellate Tax Board.

If you have any additional questions, please call (617) 727-4301.

Sincerely,

/s/ Debra S. Rokosz
Debra S. Rokosz, Chief
Abatement Bureau, Room 909

DSR:sie

APPENDIX G

Supreme Judicial Court for the
Commonwealth of Massachusetts
One Beacon Street, Third Floor,
Boston, Massachusetts 02108
(617) 557-1020

Atty. Paul H. Frankel
Morrison & Foerster LLP
1290 Avenue of the Americas
New York, NY 10104

RE: No. SJC-08935

GENERAL MILLS, INC., & others
vs.
COMMISSIONER OF REVENUE

NOTICE OF DENIAL OF PETITION
FOR REHEARING

The Petition for Rehearing filed in the above captioned case has been considered by the Court and is denied.

Susan Mellen, Clerk

Dated: October 29, 2003

TO: Maxwell D. Solet, Esquire
Thomas K. Condon, Special A.A.G.
Appellate Tax Board
Atty. Paul H. Frankel

APPENDIX H

Massachusetts Statutes Involved

Mass. Gen. Laws ch. 63, § 30

§ 30. Definitions; value of tangible property; net worth

When used in this section and sections thirty-one to fifty-two, inclusive, the following terms shall have the following meanings:

1. "Domestic corporations", every corporation organized under or subject to chapter one hundred and fifty-six, chapter one hundred and fifty-six A, chapter one hundred and fifty-six B or chapter one hundred and eighty which has privileges, powers, rights or immunities not possessed by individuals or partnerships; provided, however, that said term shall not apply to corporations organized under the provisions of section ten of chapter one hundred and fifty-seven, domestic manufacturing corporations as defined in section thirty-eight C, to corporations that qualify as regulated investment companies under section eight hundred and fifty-one of the Federal Internal Revenue Code as amended[1] and in effect for the taxable year, to corporations exempt from taxation under the provisions of section five hundred and one of the federal Internal Revenue Code, as amended[2] and in effect for the taxable year, nor to corporations subject to tax under section two. A mutual holding company subject to chapter one hundred and sixty-seven H or sections 19F to 19W, inclusive, of chapter 175, or a limited liability company formed under

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[1] 26 U.S.C.A. § 851.

[2] 26 U.S.C.A. § 501.

chapter one hundred and fifty-six C which is not classified for the taxable year as a partnership for federal income tax purposes, shall also be considered to be a corporation that is a domestic corporation for purposes of this chapter.

2. "Foreign corporations", every corporation, association, or organization established, organized or chartered under laws other than those of the commonwealth, for purposes for which domestic corporations may be organized under chapter one hundred and fifty-six, chapter one hundred and fifty-six A, chapter one hundred and fifty-six B or sections 19F to 19W, inclusive, of chapter 175, or chapter one hundred and eighty which has privileges, powers, rights or immunities not possessed by individuals or partnerships; provided, however, that said term shall not apply to such corporations, associations or organizations without capital stock as are subject to taxation under section eighteen of chapter one hundred and fifty-seven to foreign manufacturing corporations as defined in section forty-two B, to corporations, associations or organizations that qualify as regulated investment companies under section eight hundred and fifty-one of the Federal Internal Revenue Code as amended and in effect for the taxable year, to such corporations, associations or organizations as are exempt from taxation under the provisions of section five hundred and one of the federal Internal Revenue Code, as amended and in effect for the taxable year nor to such corporations, associations or organizations subject to tax under section two; provided, further, that said terms shall apply to a foreign limited liability company as defined in section two of chapter one hundred and fifty-six C, which is not classified for the taxable year as a partnership for federal income tax purposes.

3. "Gross income", gross income as defined under the provisions of the Federal Internal Revenue Code, as amended and in effect for the taxable year, plus the interest from bonds, notes and evidences of indebtedness of any state, including this commonwealth; provided, however, that gross income of corporations taxable under section thirty-eight B shall, in addition to the foregoing, include a deduction for losses from the sale or exchange of capital assets sustained during the taxable year to the extent allowable by the Federal Internal Revenue Code. The commissioner of energy resources may approve United States patents, which have been issued to Massachusetts corporations or applied for by Massachusetts corporations as useful for energy conservation and related purposes or as useful for alternative energy development and related purposes, provided that such patents are determined by said commissioner to be of economic value, practicable, and necessary for the convenience and welfare of the commonwealth and its citizens. Any income received from the sale, lease or other transfer of tangible, intangible, personal or real property or materials manufactured in the commonwealth subject to such patent shall be deducted. Said deduction shall extend for a period no longer than five years from the date of issuance of the United States patent or the date of approval by the commissioner of energy resources, whichever first expires.

4. "Net income", gross income less the deductions, but not credits, allowable under the provisions of the Federal Internal Revenue Code, as amended and in effect for the taxable year; provided, however, that any deduction otherwise allowable which is allocable, in whole or in part, to one or more classes of income not included in a corporation's taxable net income, as determined under subsection

(a) of section thirty-eight, shall not be allowed. In lieu of disallowing any deduction allocable, in whole or in part, to dividends not included in a corporation's taxable net income, five per cent of such dividends shall be includable therein, as provided in said subsection (a) of said section thirty-eight. A deduction shall be allowed for that portion of wages or salaries paid or incurred for the taxable year equal to the amount of the credit allowable for the taxable year under section fifty-one of the Federal Internal Revenue Code and otherwise disallowed under section two hundred and eighty C of said Code. Deductions with respect to the following items, however, shall not be allowed: –

(i) dividends received

(ii) Losses sustained in other taxable years, except for the net operating losses as provided in paragraph five of this section.

(iii) taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by any state.

5. (a) For purposes of this chapter, the Massachusetts net operating loss incurred in a taxable year shall mean the amount by which the deductions allowed under paragraph four, including the dividends-received deduction allowed in section thirty-eight (a)(1) and not including the deductions for net operating losses under this paragraph, exceed gross income for the taxable year as defined in paragraph three of this section.

(b) Massachusetts net operating losses which are sustained in taxable years ending on or after December

thirty-first, nineteen hundred and eighty-nine, shall be allowed as a deduction in determining net income; provided, further, that such deduction shall be limited to a percentage of the net income for the taxable year as follows:

(1) twenty-five percent of net income for taxable years ending on or after December thirty-first, nineteen hundred and ninety, and before December thirty-first, nineteen hundred and ninety-one;

(2) fifty percent of the net income for taxable years ending on or after December thirty-first, nineteen hundred and ninety-one, and before December thirty-first, nineteen hundred and ninety-two;

(3) seventy-five percent of net income for taxable years ending on or after December thirty-first, nineteen hundred and ninety-two, and before December thirty-first, nineteen hundred and ninety-three; and

(4) and one hundred percent of net income for taxable years ending on or after December thirty-first nineteen hundred and ninety-three.

Losses sustained in any taxable year may be carried forward for not more than five years and may not be carried back.

(c)(i) For the first five consecutive taxable years of a corporation, measured from the date of its organization, whether or not organized under the laws of the commonwealth, so much of the loss as determined under section one hundred and seventy-two of the Federal Internal Revenue Code, as amended and in effect for the taxable year, and adjusted for any differences between Massachusetts taxable net income and federal taxable income, as is

represented by net operating loss carryovers for taxable years ending December thirty-first, nineteen hundred and seventy-five, and thereafter may be deducted;

(ii) provided, however, that such carryover losses shall not be allowed to any corporation fifty percent or more of whose voting stock is owned by another corporation whether or not such owning corporation is taxable in this commonwealth;

(iii) provided further that in the case of a foreign corporation, losses incurred before such corporation becomes subject to tax liability in this commonwealth shall not be allowed.

6. "Taxable year", any fiscal or calendar year or period for which the corporation is required to make a return to the federal government.

7. The value of a corporation's tangible property taxable under clause (1) of subsection (a) of section thirty-two or thirty-nine shall be the book value of such of its tangible property situated in the commonwealth on the last day of the taxable year as is not subject to local taxation nor taxable under section sixty-seven. For purposes of this paragraph, "book value" means the original cost of such property, less the depreciation or amortization taken against such property on the books of the corporation maintained for making financial reports to shareholders. If the commissioner finds that a corporation has transferred its tangible property under clause (1) of subsection (a) of section thirty-two or thirty-nine for the purpose of reducing its excise under this chapter, he may determine the amount of its tangible property taxable under said section on the basis of the average of such tangible property held during the taxable year.

8. The net worth of a domestic business corporation taxable under clause (1) of subsection (a) of section thirty-two shall be such portion of the book value of its total assets on the last day of the taxable year, less the sum of (1) its liabilities on said date, (2) the book value of its tangible property situated in the commonwealth on said date and subject to local taxation, less the interest of any mortgagee therein, and (3) the book value on said date of its investment in subsidiary corporations organized in the commonwealth which represent eighty per cent or more of the voting stock of said corporations, as shall be found by multiplying said amount by such corporation's income apportionment percentage, as determined under the provisions of section thirty-eight. In determining the book value of any asset, the commissioner may disallow any reserve, in whole or in part, established with respect thereto which, in his judgment, is not reasonable and proper.

9. The net worth of a foreign corporation taxable under clause (1) of subsection (a) of section thirty-nine shall be such portion of the book value of its total assets less its liabilities on the last day of the taxable year as the book value of its tangible assets situated within the commonwealth on said date and not subject to local taxation plus the amount of its intangible assets on said date allocable to this commonwealth, as hereinafter determined, bear to the book value of its total assets on said date. The intangible assets allocable to this commonwealth shall be such portion of the book value of its total intangible assets on the last day of the taxable year, less the book value on said date of its investment in and advances to subsidiary corporations not doing business in the commonwealth which represent eighty per cent or

more of the voting stock of said corporations, as shall be found by multiplying said amount by such corporation's income apportionment percentage, as determined under the provisions of section thirty-eight. In determining the book value of any asset, the commissioner may disallow any reserve, in whole or in part, with respect thereto which, in his judgment, is not reasonable and proper. For the purpose of this paragraph, "advances" shall mean such interests in a corporation where a corporation-shareholder relationship exists, determined under such regulations as the commissioner may issue and under the provisions of section three hundred and eighty-five of the Federal Internal Revenue Code as amended[3] and in effect for the taxable year and the regulations issued thereunder.

10. "Tangible property corporation", a corporation whose tangible property situated in the commonwealth on the last day of the taxable year and not subject to local taxation is ten per cent or more of such portion of its total assets on the last day of the taxable year less those assets as are situated in the commonwealth on the last day of the taxable year and are subject to local taxation, and, for a foreign corporation, less its investment on said date in foreign corporations not registered to do business nor doing business in the commonwealth, as shall be found by multiplying said amount by such corporation's income apportionment percentage, as determined under the provisions of section thirty-eight, or a corporation which, in the judgment of the commissioner, should be so classified. For

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[3] 26 U.S.C.A. § 385.

the purpose of this paragraph, the assets of the corporation shall be valued at their book value.

11. "Intangible property corporation", a corporation whose tangible property situated in the commonwealth on the last day of the taxable year and not subject to local taxation is less than ten per cent of such portion of its total assets on the last day of the taxable year less those assets as are situated in the commonwealth on the last day of the taxable year and are subject to local taxation, and, for a foreign corporation, less its investment on said date in foreign corporations not registered to do business nor doing business in the commonwealth, as shall be found by multiplying said amount by such corporation's income apportionment percentage, as determined under the provisions of section thirty-eight, or a corporation which, in the judgment of the commissioner, should be so classified. For the purpose of this paragraph, the assets of the corporation shall be valued at their book value.

12. In any case in which the effective date or applicability of any provision of this chapter is expressed in terms of taxable years beginning or ending with reference to a specified date which is the first or last day of a month, with respect to a corporation which has elected to make a return to the federal government on the basis of an annual period which varies from fifty-two to fifty-three weeks, its taxable year shall be treated as beginning with the first day of the calendar month beginning nearest to the first day of such taxable year, or as ending with the last day of the calendar month ending nearest to the last day of such taxable year.

13. "State", any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or a political subdivision of any of the foregoing.

14. "DISC" – a corporation which meets the requirements of section 992(a)(1) of the Federal Internal Revenue Code, as amended[4] and in effect for the taxable year.

15. "Wholly-owned DISC" – a DISC all of whose outstanding shares, except directors' qualifying shares, are owned by a single corporation, either directly or indirectly through other corporations all of whose shares are owned directly or indirectly by such corporation.

Mass. Gen. Laws ch. 63, former § 38(f)
(as amended and in effect in 1988 and 1989)

GENERAL LAWS OF THE COMMONWEALTH OF MASSACHUSETTS, 1932, CHAPTER 63 TAXATION OF CORPORATIONS, Domestic Corporations.

Sec. 38. [Allocation of net income] –

The commissioner shall determine the part of the net income of a domestic business corporation or of a foreign corporation derived from business carried on within the commonwealth as follows:

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[4] 26 U.S.C.A. § 992(a)(1).

(f)

The sales factor is a fraction, the numerator of which is the total sales of the corporation in this commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in this subsection, "sales" means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities. Sales of tangible personal property are in this commonwealth if:

1.

the property is delivered or shipped to a purchaser, including the United States government, within this commonwealth regardless of the f. o. b. point or other conditions of the sale; or

2.

the corporation is not taxable in the state of the purchaser and the property was not sold by an agent or agencies chiefly situated at, connected with or sent out from premises for the transaction of business owned or rented by the corporation outside this commonwealth. "Purchaser", as used in clauses 1 and 2 of this paragraph, shall include the United States government.

Sales, other than sales of tangible personal property, are in this commonwealth if:

1.

the income-producing activity is performed in this commonwealth; or

2.

the income-producing activity is performed both in and outside this commonwealth and a greater portion of this income-producing activity is performed in this commonwealth than in any other state, based on costs of performance.

For the purposes of this subsection the corporation will be deemed to be taxable in the state of the purchaser if the tangible personal property is delivered or shipped to a purchaser in a foreign country; sales of tangible personal property to the United States government or any agency or instrumentality thereof for purposes of resale to a foreign government or any agency or instrumentality thereof are not sales made in this commonwealth; and sales by a corporation to its wholly owned DISC shall be treated as though made directly by such corporation to the customer of such DISC.

Mass. Gen. Laws ch. 63, former § 39 (as amended and in effect in 1988)

§ 39. Excise on Foreign Corporations.

Except as otherwise provided herein, every foreign corporation, exercising its charter, or qualified to do business or actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay, on account of each taxable year, the excise provided in subsection (a) or (b) of this section, which ever is greater,

except that a foreign insurance mutual holding company organized pursuant to the laws of the state in which it is established shall pay, on account of each taxable year, only the excise provided by clause (2) of subsection (a) or subsection (b), whichever is greater.

The excise levied herein is due and payable on any one or all of the following alternative incidents:

(1) The qualification to carry on or do business in this state or the actual doing of business within the commonwealth in a corporate form. The term "doing business" as used herein shall mean and include each and every act, power, right, privilege, or immunity exercised or enjoyed in the commonwealth, as an incident to or by virtue of the powers and privileges acquired by the nature of such organizations, as well as, the buying, selling or procuring of services or property.

(2) The exercising of a corporation's charter or the continuance of its charter within the commonwealth.

(3) The owning or using any part or all of its capital, plant or other property in the commonwealth in a corporate capacity.

It is the purpose of this section to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges and immunities derived by reason of the corporate form of existence and operation.

In the case of a corporation whose taxable year is a period of less than twelve calendar months, the portion of the amount determined under clause (1) of subsection (a) shall be multiplied by a fraction whose numerator is the

number of months included in the taxable year and whose denominator is twelve.

(a) An amount equal to the sum of: –

(1) Seven dollars per thousand upon the value of –

(i) its tangible property as determined to be taxable under paragraph 7 of section thirty if a tangible property corporation, or

(ii) its net worth as determined to be taxable under paragraph 9 of section thirty if an intangible property corporation; and

(2) Eight and thirty-three one hundredths per cent of its net income determined to be taxable in accordance with the provisions of this chapter.

(b) Two hundred dollars.

APPENDIX I

Relevant Excerpts of I.R.C. § 338

§ 338. Certain stock purchases treated as asset acquisitions

(a) General rule. – For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election), then, in the case of any qualified stock purchase, the target corporation –

> **(1)** shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and
>
> **(2)** shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date.

* * *

(h) Definitions and special rules. – For purposes of this section –

* * *

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidated group. –

> **(A) In general.** – Under regulations prescribed by the Secretary, an election may be made under which if –
>
> > **(i)** the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction,

then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

(B) Selling consolidated group. – For purposes of subparagraph (A), the term "selling consolidated group" means any group of corporations which (for the taxable period which includes the transaction) –

(i) includes the target corporation, and

(ii) files a consolidated return.

To the extent provided in regulations, such term also includes any affiliated group of corporations which includes the target corporation (whether or not such group files a consolidated return).

(C) Information required to be furnished to the Secretary. – Under regulations, where an election is made under subparagraph (A), the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:

(i) The amount allocated under subsection (b)(5) to goodwill or going concern value.

(ii) Any modification of the amount described in clause (i).

(iii) Any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

* * *

APPENDIX J

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September 25, 2003

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By Overnight Delivery

The Hon. Margaret H. Marshall, Chief Justice
Massachusetts Supreme Judicial Court
One Beacon Street, 3d Floor
Boston, MA 02108

Re: General Mills, Inc. v. Commissioner of Revenue,
SJC-08935 (Sept. 15, 2003)
Petition for Rehearing; Mass. R.A.P. 27

Dear Chief Justice Marshall:

Petitioner General Mills, Inc. ("General Mills") respectfully requests the Court to rehear the above-referenced matter. The Court has jurisdiction pursuant to Massachusetts Rule of Appellate Procedure 27.

The Court should grant General Mills' petition herein because: (1) it misapplied the step transaction doctrine and in doing so failed to give effect to the economic substance of the transaction – namely, a single sale of stock; and (2) General Mills raised Due Process

Clause arguments that should not have been deemed as waived.

I. BACKGROUND

In 1988, General Mills agreed to sell the stock of Talbots, Inc. ("Talbots") to Jusco Co., Ltd. ("Jusco") for $325 million. The eventual structure of the transaction was dictated by Jusco and reflects tax planning strategies advantageous to the purchaser, including Jusco's demand for an I.R.C. Section 338(h)(10) election and the separate sale of intangibles for $100 million to its European subsidiary via an intangible holding company, TalHC, Inc. ("TalHC").

As a result of Jusco's structure, neither General Mills nor Talbots ever received the $100 million of proceeds for the sale of intangibles. The $100 million paid by Jusco's European subsidiary to TalHC was immediately lent to Jusco's United States' subsidiary when on the following day Jusco acquired the stock and control of Talbots and its subsidiary TalHC. The $100 million was used to help finance the $325 million purchase of Talbots' stock. At the completion of the transaction, General Mills and Talbots only received total proceeds of $325 million, as intended from the outset, it did not receive $425 million.

II. ARGUMENT

A. The Court did not correctly apply the step transaction doctrine.

The Court determined that Talbot's contribution of its intangible assets to TalHC was a scheme with no legitimate business purpose. Slip. Op. ¶ 4 at 25-27. However, as

the Court recognized, General Mills did not create this scheme – Jusco "sought a modification to the agreement, for its own purposes." Slip. Op. ¶ 1.b. at 7. The Court viewed the transactions as collectively resulting in a sale of the entire company. But the Court in this case misapplied the step transaction doctrine because it did not collapse or ignore all of the intermediate transactions involving TalHC. The complete and correct application of the step transaction doctrine requires that the sale of intangible assets from TalHC to Jusco for $100 million be collapsed and ignored in addition to Talbot's previous contribution of intangibles of TalHC.

After citing United States Supreme Court precedents on the step transaction doctrine (*Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) and *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938)), this Court concluded that the step transaction doctrine should be applied to the intermediate transaction involving TalHC and the movement of intangibles:

> The intermediate transaction served no legitimate business purpose and was designed solely to avoid a Massachusetts tax. It is immaterial that the end result may have been for legitimate business purposes. If an intermediate step has no legitimate business purpose beyond tax avoidance, it may be collapsed for tax purposes under the step transaction doctrine.

(Slip Op. ¶ 4 at 27).[1]

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[1] If the scheme was "designed solely to avoid a Massachusetts tax[,]" Slip Op. ¶ 4, it was not a General Mills scheme. If anything, it

(Continued on following page)

Notwithstanding the finding that the transactions should be collapsed, the Court did not fully apply the step transaction doctrine. As formulated by the U.S. Supreme Court, the step transaction doctrine entails the following:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed *as a whole*, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title.

Court Holding Co., supra, 324 U.S. at 334 (emphasis added). *See also Minnesota Tea Co., supra*, 302 U.S. at 613-14 ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

In *Court Holding*, the shareholders negotiated the sale of a corporation, but instead distributed its only asset to its shareholders, who then conveyed the asset to the purchaser. *Court Holding Co., supra*, 324 U.S. at 332-33. The *Court Holding* Court held the transfer was a nullity because it was in substance a sale of the corporation to the

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was a Jusco scheme for its ownership of Talbots *after* the Jusco acquisition, *i.e.*, to obtain deductions for royalties paid to the Jusco European subsidiary. Following the collapse of the transactions into a single stock-sale, the Department is free to disallow those deductions. *See Syms Corp. v. Comm'r of Revenue*, 436 Mass. 505 (2002).

purchaser. *Id.* at 333-34. That Court disregarded the asset transfer, collapsed the transfer into the corporation, and held the transactions to be taxed as if the scheme had not been perpetrated, *i.e.*, a stock-sale of the corporation by the shareholders. *Id.* at 333-334.

In *Minnesota Tea*, the stockholders arranged for the sale of the corporation's assets but immediately transferred its debts and cash from the sale of the assets to its shareholders under the guise of a reorganization. *Minnesota Tea Co., supra*, 302 U.S. at 611-12. The *Minnesota Tea* Court held that the scheme was in substance a sale by the corporation, although in form it was a reorganization. *Id.* at 612. That Court disregarded the transfers, collapsed the transfers into the corporation, and held that the transaction is to be taxed as if the scheme had not been perpetrated.

Finally, the United States Tax Court describes the step transaction doctrine as a "rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987).

If the step transaction doctrine as prescribed by the United States Supreme Court in *Court Holding* and *Minnesota Tea*, as well as the U.S. Tax Court in *Penrod*, is applied to the facts of the present case, the substance and intended result of the transaction dictates that the sale of intangibles to Jusco's European subsidiary be ignored. The fact that the $100 million of proceeds for the sale of intangibles was not retained by either General Mills or Talbots but rather returned to Jusco to finance the $325 million acquisition of Talbots stock clearly indicates that the sale

of the intangibles was an intermediate and interdependent step to the intended result – namely, the sale of Talbots stock. Moreover, because the $100 million of proceeds was not retained by either General Mills or Talbots, but rather returned to Jusco, the transaction represents no independent, economic substance other than the minimization of income taxes. This Court should grant this petition for rehearing to ensure the complete application of the step transaction doctrine.

B. The Court overlooked General Mills' Due Process Clause arguments.

General Mills raised Due Process Clause arguments on pages 8-9, 18-19, and 28 of its brief.[2] In footnote seven, the Court stated that the Due Process Clause arguments had not been raised and, therefore, were deemed waived. Slip Op. ¶ 3 at note 7.

On pages 18 and 19 of its brief, General Mills noted that the Appellate Tax Board ("Board") rejected the Commissioner's attempt to tax gain from the sale of non-unitary subsidiaries. The Court affirmed that rejection, in paragraph 2 of its decision, when it analyzed and affirmed the Board's determination that Eddie Bauer and General Mills did not have a unitary business relationship and therefore this State could not tax the Eddie Bauer stock sale under the United States Constitution.

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[2] General Mills combines herein these Due Process Clause arguments and the Commerce Clause requirements which were also addressed in General Mills' brief, at pages 8-9, 18-19, and 28, but were not specifically addressed in this Court's opinion.

General Mills similarly asserted the unconstitutionality of the Commonwealth of Massachusetts Department of Revenue's ("Department") apportionment of the Talbots transaction on pages 8 and 9 and cited *Allied Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO Inc v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); and *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354 (1982). Then on page 28 of its brief, General Mills specifically said:

> If the Board is correct in its decision that Talbots' creation of TalHC should be ignored, then we are left with the stock sale by General Mills. The Board, having found that General Mills and its non-packaged food related subsidiaries were non-unitary, and non-operationally related, should have found that the sale was not taxable by Massachusetts in any form – not as a stock sale and not as a fictional asset sale. *Allied Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992) [.]

Allied Signal was cited because it holds specifically that a state's apportionment of a company's sale of stock of a non-unitary business is violative of the Due Process and Commerce Clauses of the United States Constitution. General Mills' explained and argued those constitutional points on pages 8, 9, 18, 19, and 28 of its brief.

The Court compared the hypothetical sale of Talbots' assets to a possible sale of Talbots' assets. Slip Op. ¶ 3 at 23-24. The correct comparison should be to what happened, *i.e.*, a sale of stock by General Mills. Because the Board properly determined that Talbots was not unitary with General Mills, the Talbots stock sale should not have been taxable under the United States Constitution for the

same reasons that the Eddie Bauer stock sale could not be taxed.

* * *

For the foregoing reasons, it is respectfully requested that the Court rehear this matter.

Respectfully submitted,

/s/ Paul H. Frankel
Paul H. Frankel
Attorney for Petitioner-Appellant

cc: Thomas K. Condon, Counsel for the Commissioner

APPENDIX K

COMBUSTION ENGINEERING, INC., AND COMBINED SUBSIDIARIES v. COMMISSIONER OF REVENUE

Docket No. F228740

COMMONWEALTH OF MASSACHUSETTS – APPELLATE TAX BOARD

2000 Mass. Tax LEXIS 17

March 29, 2000

[*1] Jonathan M. Zorn, Esq. and Steven A. Kaufman, Esq., for the appellant.

Kevin M. Daly, Esq., for the appellee.

BURNS

This is an appeal under the formal procedure pursuant to G.L. c. 62C, § 39, from the refusal of the appellee to abate a corporate excise assessed against the appellant for the taxable period ending December 31, 1988.

Chairman Gurge heard the appeal and was joined in the decision for the appellant by Commissioners Scharaffa, Burns, Gorton and Egan.

These findings of fact and report are made pursuant to a request by the appellee under G.L. c. 58A, § 13 and 831 CMR 1.32.

FINDINGS OF FACT AND REPORT

This appeal was submitted to the Appellate Tax Board ("Board") on an agreed statement of facts. On the basis of the agreed statement, the Board made the following findings of fact.

At all relevant times, Combustion Engineering, Inc. ("CEI") was a foreign corporation subject to the Massachusetts corporate excise. Jamesbury Corporation was a subsidiary of CEI, acquired in 1984, actively engaged in business in the Commonwealth. Jamesbury was a part of CEI's consolidated and combined return group up to the date its stock was sold, and participated in CEI's federal [*2] consolidated and Massachusetts combined returns.

In September 1988, CEI sold its Jamesbury stock to Neles, Inc. CEI and Neles elected under § 338(h)(10) of the Internal Revenue Code ("Code") to treat the sale for federal income tax purposes, as a sale of Jamesbury's assets. Due to the election, Jamesbury recognized a gain on the "deemed sale" of its assets. Correspondingly, CEI did not recognize gain when it sold the Jamesbury stock to Neles.

On October 18, 1989 CEI filed its Massachusetts combined return for 1988 that included Jamesbury's income for the short-year period preceding the sale to Neles. Jamesbury's income subject to apportionment for the short-year period included the gain on the deemed sale of Jamesbury's assets attributable to the § 338(h)(10) election. CEI apportioned Jamesbury's income to Massachusetts for 1988 by including in the "sales factor" under G.L. c. 63, § 38, the amount of the deemed gain. Subsequently, the Commissioner of Revenue ("Commissioner") assessed additional taxes by including in the "sales factor" the gross proceeds from Jamesbury's deemed sale of assets.

CEI timely filed an application for abatement in which it claimed that no part of the proceeds [*3] from the subject transaction should be included in the sales factor.

The Commissioner denied the application for abatement and CEI timely filed its appeal with this Board. Accordingly, the Board found that it had jurisdiction over this appeal.

For the reasons explained in the following Opinion, the Board found that the gain realized on the § 338 deemed sale of Jamesbury's assets was properly included in Jamesbury's Massachusetts net income. The Board further found that no portion of the gross proceeds or the gain realized from the sale of CEI's Jamesbury stock was includable in either the numerator or the denominator of Jamesbury's "sales factor" for the taxable year at issue under G.L. c. 63, § 38.

OPINION

The sole issue in the present appeal is whether in apportioning its net income subject to the Massachusetts corporate excise, Jamesbury was required to include in the "sales factor," the proceeds received from its deemed sale of assets.

Every domestic and foreign corporation engaged in business in the Commonwealth is required to pay an excise based in part on its net income. G.L. c. 63, § 39. If two or more domestic or foreign corporations participate in the filing of a federal [*4] consolidated return, they may elect to compute their Massachusetts corporate excise based on their combined net incomes. G.L. c. 63, § 32B. The corporations' combined net income is ascertained by first separately determining the taxable net income of each corporation apportioned to this Commonwealth and then adding together each corporation's separately determined net income. Id.

Computation of a corporation's Massachusetts net income generally starts with its federal gross income as defined under the Code, as in effect for the taxable year, with some exceptions not relevant to this appeal. G.L. c. 63, § 30.

For federal tax purposes, the parties to the subject transaction elected the treatment available under § 338 of the Code. Section 338 provides, in pertinent part:

> If a purchasing corporation makes an election under this section . . . then, in the case of any qualified stock purchase, the target corporation –
>
> (1) Shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and
>
> (2) Shall be treated as a new corporation which purchased all of the assets . . . at the beginning of the day after the [*5] acquisition date. (Emphasis added).

I.R.C. § 338(a).

The result of the election is twofold. First, the target corporation, the corporation whose stock is being sold, recognizes a gain based on the difference between the basis of its assets and the assets' fair market value. I.R.C. §§ 1001 and 1245. This gain is then included in the target corporation's federal gross income. Also, the target corporation gets a stepped-up basis in the assets. I.R.C. § 338(b). Second, if the target corporation and the corporation selling the stock are part of a consolidated group and the target corporation has recognized the gain, then the selling corporation does not recognize gain at the time the stock is sold. I.R.C. § 338(h)(10)(A).

In the present appeal, CEI sold its Jamesbury stock to Neles and the parties made a § 338 election. As a result, Jamesbury was treated as if it had sold its assets for fair market value. The resulting gain was then included in its federal gross income and correspondingly its Massachusetts net income subject to apportionment. Since CEI and Jamesbury were part of a consolidated group prior to the sale, there was no gain recognized by CEI when it sold the Jamesbury stock. [*6]

After determining the corporations' net income, the next step is to determine the Massachusetts tax due pursuant to G.L. c. 63, § 38. Where, as here, a corporation has income from business activity taxable both in Massachusetts and elsewhere, its taxable net income is apportioned to Massachusetts by means of a three-factor formula based on the ratio of its Massachusetts property, payroll and sales to its property, payroll and sales everywhere. G.L. c. 63, § 38(c)-(f).

For purposes of determining a corporation's sales factor, the statute defines the term "sales" as the "gross receipts of the corporation except . . . gross receipts from the . . . disposition of securities." (emphasis added). G.L. c. 63, § 38(f). Based on this definition of "sales," CEI argued that the proceeds generated from the sale of the Jamesbury stock were exempt from inclusion in the Massachusetts apportionment formula. The Commissioner, however, argues that since CEI made a § 338 election to have the transaction treated as a sale of assets, that all proceeds from the sale were gross receipts includable in the "sales factor."

In support of its position, the Commissioner relies on the fact that Massachusetts [*7] follows the federal Code.

The Commissioner is correct in part in that the Massachusetts statute uses the federal gross income, as determined by the Code, as a starting point for determining a corporation's "gross income". However, the Supreme Judicial Court has consistently held that income for federal and state purposes is not always the same. See, e.g. *Rohrbough, Inc. v. Commissioner of Revenue*, 385 Mass. 830 (1982).

> The reference is to the provisions of the Internal Revenue Code and not simply to the amount of gross income shown on a taxpayer's Federal income tax return for the same tax year. Although the figure shown as gross income on a taxpayer's Federal return will normally be the gross income for State tax purposes for the same tax year, this is not always the case.

Id. at 832.

In this case, the question is not a difference between CEI's federal and state gross income. On both its federal consolidated and state combined returns, CEI included in Jamesbury's taxable income the gain recognized from the § 338 election. The issue here is whether those proceeds were to be included in the "sales factor." The apportionment formula contained in G.L. c. 63, § [*8] 38 makes no reference to the Code. Instead, this section defines the necessary terms. The statute is clear that receipts generated from the sale of stock are not "sales" for purposes of the sales factor. G.L. c. 63, § 38(f).

Section 338 of the Code specifically states that "in the case of any qualified stock purchase . . . [the corporation whose stock is being sold] shall be treated as having sold all of its assets." I.R.C. § 338(a) (emphasis added). In an

analogous situation, the Board declined to attach Massachusetts tax significance to "a fictitious transaction deemed to have taken place for [federal] tax purposes." *Weston Marketing Corp. v. Comm'r of Revenue*, 16 Mass. App. Tax Bd. Rep. 76, 80 (1994). In *Weston*, the taxpayer was a holder of "regulated futures contracts." Pursuant to § 1256 of the Code, the taxpayer was required at the end of the year to "mark-to-market" the commodities; that is, to recognize a gain or loss as if the commodities had been sold on the last day of the year. On its 1981 federal tax return, the taxpayer reported a net capital loss, based on the mark-to-market rules, and reported no income on its state return. In 1982, the [*9] taxpayer disposed of certain commodities and reported on its federal return a net capital gain, a portion of which reflected a recapture of the prior year's mark-to-market net loss. On its state return for 1982, the taxpayer excluded the recapture of the prior year's loss reported on its federal return.

The Board concluded that although the Code required, for federal tax purposes, the recapture of losses taken for the prior year's "fictitious transaction," there was no "actual realization of income" subject to taxation in Massachusetts. *Weston*, 16 Mass. App. Tax Bd. Rep. 76, 80. See also *Rohrbough*, 382 Mass. 833; *T.H.E. Investment Corporation v. Commissioner*, 8 Mass. App. Tax Bd. Rep. 12 (1986) (taxpayer not required to include in state gross income the recapture of income generated from losses taken for federal, but not state, purposes in prior years.)

It is well established that "the right to tax must be found within the letter of the law and is not to be extended by implication." *Grady v. Commissioner of Revenue*, 421 Mass. 374, 377 quoting *Commissioner of Revenue v. Molesworth*, 408 Mass. 580, 581 (1990). Tax statutes are to

be starkly construed [*10] according to their plain meaning. *Commissioner of Revenue v. Franchi*, 423 Mass. 817, 822. All ambiguities in interpreting the statute must be resolved in favor of the taxpayer. *Grady*, 421 Mass. at 374.

Accordingly, the Board found that the federal treatment of the sale – based on a fictitious recasting of the actual transaction for purposes of federal tax law – does not determine whether the proceeds of the transaction should be treated as a "sales" for purposes of the Massachusetts apportionment formula. Whatever the transaction may be "deemed" to be for federal purposes, it is, in actuality, a sale of stock, the proceeds from which are specifically excluded from the sales factor.

The Commissioner's regulation, 830 CMR 38.1(9)(b)7, promulgated in August, 1995, long after the 1988 transaction at issue and after the instant appeal was filed, is not persuasive on the issue of how § 38 should be interpreted in this appeal. The regulation was neither promulgated contemporaneously with the enactment of § 38 (See *Xtra, Inc. v. Commissioner of Revenue*, 380 Mass. 277, 282 (1980)) nor is it consistent with the plain wording of the statute. See *Electronics Corporation* [*11] *of America v. Commissioner of Revenue*, 402 Mass. 672, 676-677 (1988).

For all of the foregoing reasons, the Board issued a decision for the appellant in this appeal.

APPELLATE TAX BOARD

By: Abigail A. Burns, Chairman